1934

Auditing: theory and practice

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Boston University

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Boston University
CHAPTER 23
THE VERIFICATION OF PLANT PROPERTY ACCOUNTS

395. Description.

396. Explanation of Plate 125.
   PLATE 125--A Summary Schedule of Property Accounts. (1st type).

397. Explanation of Plate 126.
   PLATE 126--A Summary Schedule of Property Accounts. (2d type).

398. Explanation of Plate 127.
   PLATE 127--A Summary Schedule of Property Accounts. (3d type).

399. The Composition of the Accounts.

400. Explanation of Plate 128.
   PLATE 128--A Property Ledger Card.

401. Explanation of Plate 129.
   PLATE 129--A Summary of Additions to Machinery.

402. Explanation of Plate 130.
   PLATE 130--A Schedule on Property Authorizations.

403. The Verification Procedure.

404. Retirement of Property.

405. Comments on Balance Sheet Presentation.


407. Explanation of Plate 131.
   PLATE 131--A Property Classification.

407a. General Audit Program.

Review Questions:

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395. Description.--Plant Property (Plate 125) is equivalent to the probably more common term of tangible fixed assets, and includes land, buildings, building equipment, furniture and fixtures, machinery and equipment, betterments to leased property, tools, patterns and drawings, horses, harness, wagons, trucks, and so on.

396. See Plate 125.

397. See Plate 126.

398. See Plate 127.

399. The Composition of the Accounts.--Although no clear-cut nor absolutely infallible rule can be given the reader for determining in all cases whether or not an item is a capital or a revenue charge, it is possible to give a good working rule applicable in the case of mercantile and industrial enterprises. The item should represent an increase in the property, or in the efficiency or earning capacity of an asset. In the case of such items as patterns, tools, and dies, the test usually is: Is there any real value present from the point of view of a going concern basis? On the other hand, if an expenditure merely maintains an asset at its previous efficiency or earning capacity, it should be charged to Repairs and Maintenance.

In general, all invoice and other costs of a piece of property are properly capitalized if the property has a life and use extending beyond the present accounting period. However, large businesses often have a working rule whereby all property expenditures below, say $50, are expensed, no matter if the asset is clearly useful into the future. This procedure therefore, is a very convenient and practical device for large concerns to secure conservative results. It is, however, neither correct in theory, nor applicable to small concerns. At all times reasonableness must prevail.

In regard to applying overhead on the jobs which the factory production

2I.E. occasional special jobs, NOT applicable if fairly constant in volume.
EXPLANATION OF PLATE 125

A SUMMARY SCHEDULE OF PROPERTY ACCOUNTS

THE HOLDEN WOOLEN MILLS
Summary of Property, and Depreciation Reserves
Audit For the Year Ending Feb. 28, 1930

396. Explanation and Comments.—On this master schedule are summarized twenty-two schedules (M1-M22) for presentation on the balance sheet. Thus land will be shown at $30,213.39, buildings and equipment at $533,334.26, etc. And the same thing has been done with the reserves for depreciation.

Note that the figures have been tabulated so as to bring out the changes during the year. This sort of arrangement is always vital to a proper appreciation of what has been going on during the year in the way of expansion or retrenchment.

In the writer’s opinion, this schedule could be improved by showing the gross additions and deductions rather than the net changes. On this basis, the item for Buildings and Equipment (M3) might have been as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>146,617.19</td>
<td>31,536.19</td>
<td>178,096.34</td>
<td>3,249.14</td>
<td>34,631.18</td>
<td>259.04</td>
<td>259.04</td>
<td></td>
</tr>
</tbody>
</table>

The grand summary at the bottom of the schedule would, of course, then be drawn up on this same basis.

Each one of the subschedules represents either a different piece or class of property. Thus, for example, M-1 may be the land at the Hinghamton, Mass. factory, whereas M-2 may be the land at Central Falls, R.I. factory. Again, for example, M-8 may be the schedule on looms, whereas M-9 may be the one on the carding machinery, and so on.
# A SUMMARY SCHEDULE OF PROPERTY ACCOUNTS: PLATE 125

## The Holden Woolen Mills

### Summary of Property and Depreciation Reserves

**Audit for the Year Ending February 28, 1930**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Land</strong></td>
<td>20142.07</td>
<td>20142.07</td>
<td>0</td>
<td>20142.07</td>
<td>20142.07</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>30213.39</td>
<td>30213.39</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Bldg &amp; Eq.</strong></td>
<td>148817.19</td>
<td>178096.34</td>
<td>31279.15</td>
<td>13641.09</td>
<td>34631.18</td>
<td>2990.09</td>
</tr>
<tr>
<td><strong>Mach &amp; Eq.</strong></td>
<td>81600.47</td>
<td>60147.91</td>
<td>(1452.56)</td>
<td>8889.63</td>
<td>9389.07</td>
<td>762.44</td>
</tr>
<tr>
<td><strong>Rucks</strong></td>
<td>117814.32</td>
<td>119409.68</td>
<td>1595.35</td>
<td>22478.34</td>
<td>24478.26</td>
<td>1999.26</td>
</tr>
<tr>
<td><strong>Furn &amp; Fix.</strong></td>
<td>90146.39</td>
<td>90496.39</td>
<td>350.00</td>
<td>9569.09</td>
<td>10367.35</td>
<td>799.26</td>
</tr>
<tr>
<td><strong>Water Right</strong></td>
<td>65183.94</td>
<td>65183.94</td>
<td></td>
<td>7124.57</td>
<td>9429.26</td>
<td>2295.69</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>501562.51</td>
<td>533334.26</td>
<td>31771.95</td>
<td>79632.72</td>
<td>88486.12</td>
<td>8853.40</td>
</tr>
</tbody>
</table>

### OMISSIONS

<table>
<thead>
<tr>
<th>Item</th>
<th>Original</th>
<th>Original</th>
<th>Original</th>
<th>Original</th>
<th>Original</th>
<th>Original</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brucks</td>
<td>M18</td>
<td>13817.91</td>
<td>10107.91</td>
<td>(3710.00)</td>
<td>6671.42</td>
<td>5558.65</td>
</tr>
<tr>
<td>Furn &amp; Fix</td>
<td>M19</td>
<td>27961.42</td>
<td>51037.61</td>
<td>3116.19</td>
<td>10910.17</td>
<td>14399.41</td>
</tr>
<tr>
<td>Water Right</td>
<td>M20</td>
<td>15000.00</td>
<td>15000.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dams, Etc.</td>
<td>M21</td>
<td>42189.74</td>
<td>45187.09</td>
<td>977.35</td>
<td>12698.49</td>
<td>13687.53</td>
</tr>
<tr>
<td>Patterns</td>
<td>M22</td>
<td>8094.51</td>
<td>5883.41</td>
<td>(2230.90)</td>
<td>2632.18</td>
<td>2096.32</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td>1297378.31</td>
<td>1455952.10</td>
<td>148573.79</td>
<td>378792.12</td>
<td>27230.60</td>
<td></td>
</tr>
</tbody>
</table>

### SUMMARY

<table>
<thead>
<tr>
<th>Item</th>
<th>Original</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Land</strong></td>
<td>30213.39</td>
</tr>
<tr>
<td><strong>Bldg &amp; Equip</strong></td>
<td>501562.51</td>
</tr>
<tr>
<td><strong>Mach &amp; Equip</strong></td>
<td>658519.23</td>
</tr>
<tr>
<td><strong>Trucks</strong></td>
<td>13917.91</td>
</tr>
<tr>
<td><strong>Furn &amp; Fix.</strong></td>
<td>27981.42</td>
</tr>
<tr>
<td><strong>The Others</strong></td>
<td>57189.74</td>
</tr>
<tr>
<td><strong>Patterns</strong></td>
<td>8094.51</td>
</tr>
</tbody>
</table>

| **Total** | 1297378.31 |

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**Pl. 125**

P. Holt

3/16/30

M.
THE HESSELTIME MFG. CO.
Plant Properties
Audit for the Year Ending Aug. 31, 1931

<table>
<thead>
<tr>
<th>Schedule M</th>
<th>1931</th>
<th>1930</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per G/L and per our audit papers 8/31/30</td>
<td>6814391.47</td>
<td>6446272.13</td>
</tr>
<tr>
<td>Add: New Construction Projects authorized by the Fin. Com.</td>
<td>(M-1) 329178.62</td>
<td>(M-1) 589614.34</td>
</tr>
<tr>
<td>Other additions to plant properties</td>
<td>(M-2) 8081.73</td>
<td>19710.36</td>
</tr>
<tr>
<td>Auditor's Adjustment #18</td>
<td>(M-1) 3538.21</td>
<td>(1096.24)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>7155190.03</strong></td>
<td><strong>7054501.09</strong></td>
</tr>
<tr>
<td>Deduct: Retirements, Sales, Etc.</td>
<td>(M-3) (121745.94)</td>
<td>(M-3) (236417.76)</td>
</tr>
<tr>
<td>Auditor's Adjustment #19</td>
<td>(M-3) (6893.47)</td>
<td>(M-3) (3691.86)</td>
</tr>
<tr>
<td>Balance per G/L and per our B/S 8/31/31</td>
<td><strong>7026650.62</strong></td>
<td><strong>6814391.47</strong></td>
</tr>
</tbody>
</table>

397. Explanation and Comments.—Note that the schedule is so drawn up as to enable the auditor's superior to grasp at a glance the situation in regard to the changes during the year in the plant properties. Also, observe that the schedule is drawn up on a two year comparative basis. This is also the type of information that should be embodied in the comments of the report.

Finally, notice that each figure is substantiated by a schedule. In some instances this subschedule may be supported by a further subschedule.
departments do for the concern's own use, the proper practice is to add only those extra overhead items which have been incurred solely because of this work. In brief, as factory operating costs are reduced in proportion to the factory overhead absorbed by work done for home use, this plan must not be adopted, because production operations are not generally reduced on account of the new construction work or the ordinary repairs.

The following is inserted at this point as an illustration of the type of schedule that auditors often draw up on jobs which are undertaken by the production departments for home use.

<table>
<thead>
<tr>
<th>Order No.</th>
<th>Quan.</th>
<th>Description</th>
<th>Mfg. Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>D.Mat. D.Labor Mfg. Exp. Total</td>
</tr>
</tbody>
</table>

[Each subdivision of the manufacturing cost should be further analyzed by sub-schedules to whatever extent the auditor deems necessary].

On the other hand, if the concern has a good cost system whereby the overhead for the Maintenance Department is known, it is very proper for the accountant to apply this departmental rate to all construction and maintenance jobs done by this SERVICE department alone. But if a business simply knows that in general its total factory and maintenance overhead is 185% of its direct labor cost, including the payroll of the maintenance department, the application of overhead at this rate to construction and maintenance projects done by the Maintenance Department alone must be rejected, because it is a very unreliable rate. A small and reasonable percent of overhead, however, is proper.

If the WRONG procedure of applying factory overhead of Production Departments to jobs done for internal use is carried out, the book entry for the application of the overhead can be portrayed as follows:

(1) Reserve for Deprec.; (2) Repairs; or (3) Asset (specifically named) xxx

Credits to Applied Overhead of the Factory Prod. Depts. Concerned xxx

(In particular case the proper one of the three debit accounts is used)

ILLUSTRATION

Thus, to be specific, suppose that a part of a machine has been built within the factory to replace the part which has been worn out. The correct entry for the overhead distribution on the INCORRECT basis would be as follows:

Reserve for Depreciation—Machinery 2
Applied Overhead Dept. A 135
" " " " K 70
" " " " R 25
" " " " 40

(To charge the "Reserve" for factory overhead applied to JOB #8)

1If the shop is working at less than normal capacity when the plant assets for "home use" are being made, there is undoubtedly good reason for charging in to the total cost thereof the standard rate of overhead regularly applied to "outside" jobs.

2I.E., an estimate of the rate of the Maintenance Department.

3The cost of the new part being the same as the cost of the old one.
### Summary of Plant Properties

**Audit for the Year Ended May 31, 1930**

#### (LEFT SIDE)

<table>
<thead>
<tr>
<th>Description</th>
<th>Blackstone</th>
<th>Pawtucket</th>
<th>Woonsocket</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Land - Balance per G/L and our papers 5/31/29</td>
<td>113862.57</td>
<td>258916.41</td>
<td>377819.45</td>
</tr>
<tr>
<td>2 Additions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Deductions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Balances 5/31/30</strong></td>
<td>113862.57</td>
<td>258916.41</td>
<td>393251.07</td>
</tr>
<tr>
<td>1 Machinery - Ditto</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Additions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Transfers</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Deductions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Balances 5/31/30</strong></td>
<td>703614.12</td>
<td>1410563.07</td>
<td>1996321.42</td>
</tr>
<tr>
<td>1 Buildings - Ditto</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Additions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Deductions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Balances 5/31/30</strong></td>
<td>742852.67</td>
<td>1436775.59</td>
<td>1928044.16</td>
</tr>
<tr>
<td>1 Building Equipment - Ditto</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Additions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Deductions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Balances 5/31/30</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Machine Tools - Ditto</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Additions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Deductions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Balances 5/31/30</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Furniture and Fixtures - Ditto</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Additions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Deductions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Balances 5/31/30</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**GRAND TOTALS**

#### SUMMARY

1 Total Plant per G/L and our papers 5/31/29
2 Total Additions
3 Real
4 Transfers
5 Total Deductions
6 Real
7 Transfers
8 Total Plant per G/L 5/31/30

**OMISSIONS**

See Plate 127b for the "Explanation and Comments".
<table>
<thead>
<tr>
<th>Warren</th>
<th>Bristol</th>
<th>Fall River</th>
<th>New Bedford</th>
<th>Providence</th>
<th>Cranston</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>198653.20</td>
<td>250000.00</td>
<td>468739.88</td>
<td>367812.44</td>
<td>350000.00</td>
<td>105679.24</td>
<td>2491483.19</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>15431.62</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>10785.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>198653.20</td>
<td>250000.00</td>
<td>468739.88</td>
<td>367827.44</td>
<td>350000.00</td>
<td>105679.24</td>
<td>2496129.61</td>
</tr>
</tbody>
</table>

|        |        |        |        |        |        |        |
|        |        |        |        |        |        |        |
| 695814.37 | 1099865.69 | 2911025.62 | 1769687.85 | 1596675.03 | 789154.32 | 12863921.89 |
| 97562.41 | 65817.12 | 59505.99 | 85463.19 | 56891.30 | 38985.25 | 561327.66 |
| 589.63 |        |        |        | 1814.97 |        | 20217.02 |
| 18763.09 | 30056.81 | 21151.65 | 31569.38 | 25966.61 | 45946.62 | 249665.57 |
|        | 589.63 |        |        | 17812.42 | 1814.97 | 20217.02 |
|        |        |        |        |        |        |        |
| 765233.32 | 1135036.57 | 2949380.16 | 1822581.66 | 1613562.07 | 782376.96 | 13175384.36 |

|        |        |        |        |        |        |        |
|        |        |        |        |        |        |        |
|        |        |        |        |        |        |        |
|        |        |        |        |        |        |        |

**Omissions**

|        |        |        |        |        |        |        |
|        |        |        |        |        |        |        |
|        |        |        |        |        |        |        |
|        |        |        |        |        |        |        |
|        |        |        |        |        |        |        |
|        |        |        |        |        |        |        |
|        |        |        |        |        |        |        |

**Summary**

The small letters at the extreme right are the various subschedules.

G These amounts were forwarded to the master schedule G.
398. Explanation and Comments. — As can be seen, PLATE 127a supports the Master Schedule 3, and is itself supported by subschedules G1-a to G1-q inclusive.

The Master Schedule 3 is as follows:

<table>
<thead>
<tr>
<th>Name of Mills</th>
<th>Description</th>
<th>B/S Audit for Year Ended May 31, 1930</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Labor to remove to junk pile, etc.</td>
<td>Gl-j</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Journal Page Reference</td>
</tr>
</tbody>
</table>

Adjustments

<table>
<thead>
<tr>
<th>Per Book 5/31/30 No.</th>
<th>Amount</th>
<th>Final 5/31/30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance 5/31/29 per G/L and our audit papers</td>
<td>25,768,143.98</td>
<td>25,768,143.98</td>
</tr>
<tr>
<td>Additions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,634,829.05</td>
<td>21</td>
<td>9,813.20</td>
</tr>
<tr>
<td>22</td>
<td>12,667.15</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>1,880.76</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>3,471.42</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>27,492,973.03</td>
<td>27,492,973.03</td>
</tr>
<tr>
<td>Deductions</td>
<td>961,056.32</td>
<td>25</td>
</tr>
<tr>
<td>Total Adjusted Balance 5/31/30</td>
<td>26,447,114.71</td>
<td>747.92</td>
</tr>
<tr>
<td>G-1</td>
<td>26,442,366.53</td>
<td></td>
</tr>
</tbody>
</table>

The subschedules, on the other hand, give specifically a detailed description of the items and values making up the additions, transfers, and deductions. Thus G1-b gives the description of the machinery added during the year in the nine mills. And, G1-j (this schedule) gives the description of the machinery scrapped and/or sold during the year in the nine mills.

The total plant property at each of the several plants is found on the line marked "GRAND TOTALS" (See schedule 127a). These same figures are, of course, found on the line marked "Total Plant per G/L 5/31/30" under the section marked "SUMMARY".
| Scrap Value | Charge to P & L on Cost of Value Depreciation Allowance Retirement Asset Transfers Remarks |
|-------------|------------------------------------------|------------------------------------------|------------------------------------------|------------------------------------------|------------------------------------------|
| 175.00      | 1612.50       | (67.50)       | 1720.002 | From Dept K 15yr.                        |
| 541.00      | 11948.15      | 372.85        | 12862.00 | None                                     |
| 2986.43     | 245769.12     | 1109.82       | 249665.37| 20217.02                                |

To FF-2    To T/B 107 To G-1 To G-1 
L Labor etc. items

**AUDIT PROCEDURE**

Small items are always charged in full to the allowance for depreciation on the theory that they are fully depreciated, except for any scrap value. All large items, however, are charged to the allowance account only for the amount accumulated to date against the particular asset retired.

All of the entries were approved by the Maintenance Superintendent, and those marked (Z) were tested by us for accuracy. The tests were necessarily very few as the Company has no satisfactory records. We are satisfied, however, that the figures are reasonably accurate. The Maintenance Supt. showed us 5 letters from manufacturers to whom he had written for prices, etc. on assets with whose value, etc. he was not familiar.

**Possible Adjustment**

Providence Mill - Sold for cash to Baker Goodman Corp. 14 -11" Franco Bevel Gear Generators for $16,181.69. This alone was credited to the account. No adjustment was made for accrued depreciation. The accrued depreciation is $30,090.41. The cost is $42,986.30.

Reserve for Depreciation - Machinery 30,090.41
Gain and Loss on Retirement of Plant Property 3,285.80)Taken up
Plant Property 26,804.61)in adj. 
#25 MP
The situation may be depicted somewhat as follows (the direct labor and materials having been credited direct to their respective accounts):

<table>
<thead>
<tr>
<th></th>
<th>$\text{xxx}</th>
<th>$\text{xxx}</th>
<th>$\text{xxx}</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Sales</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cost of Goods Manufactured:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goods in Process</td>
<td>$\text{xxx}$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raw Materials Used</td>
<td>$\text{xxx}$</td>
<td></td>
<td>$\text{xxx}$</td>
</tr>
<tr>
<td><strong>Direct Labor</strong></td>
<td>$\text{xxx}$</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Manufacturing Expenses:</strong></td>
<td>$\text{xxx}</td>
<td>$\text{xxx}</td>
<td>$\text{xxx}$</td>
</tr>
<tr>
<td>A</td>
<td>$\text{xxx}$</td>
<td>$\text{xxx}$</td>
<td>$\text{xxx}$</td>
</tr>
<tr>
<td>B</td>
<td>$\text{xxx}$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>$\text{xxx}$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>\ldots</td>
<td>$\text{xxx}$</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$\text{xxx}$</td>
<td>$\text{xxx}$</td>
<td>$\text{xxx}$</td>
</tr>
<tr>
<td>Less-overhead Applied to Internal Jobs</td>
<td>$\text{xxx}$</td>
<td></td>
<td>$\text{xxx}$</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$\text{xxx}$</td>
<td>$\text{xxx}$</td>
<td>$\text{xxx}$</td>
</tr>
<tr>
<td>Less-Goods in Process</td>
<td>$\text{xxx}$</td>
<td>$\text{xxx}$</td>
<td>$\text{xxx}$</td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td>$\text{xxx}$</td>
<td>$\text{xxx}$</td>
<td>$\text{xxx}$</td>
</tr>
</tbody>
</table>

Thus it is clear that the cost of goods manufactured is reduced by the amount of overhead which is applied to internal jobs, and the gross profit becomes greater because of it. That is, a profit is taken up on jobs done for internal use to the extent that overhead (not specifically incurred for these particular jobs) is absorbed as a cost.

In the case of appraisals, care must be exercised by the auditor to see that the excess of the appraised value over the existing book value is properly divided between capital surplus and earned surplus, if any. Thus if an appraisal report found (1) that $340,000 worth of assets had been incorrectly expensed; (2) that the pure gross appreciation increment of all assets was $385,000; and (3) that the depreciation reserve was $45,000 too small ($25,000 on the expensed and the old items, and $20,000 on the gross appraisal increment), the proper entry would be as follows:

<table>
<thead>
<tr>
<th>Assets (by name)</th>
<th>125,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deprec. Reserves (by name)</td>
<td>45,000</td>
</tr>
<tr>
<td>Appraisal Surplus - Plant Properties</td>
<td>65,000</td>
</tr>
<tr>
<td>Earned Surplus</td>
<td>15,000</td>
</tr>
</tbody>
</table>

If properties are paid for with stocks and bonds, the directors will usually establish the values (generally the par value of the securities) to be used in the books of account. The auditor must accept this situation without correction, unless there is a clear case of fraud, even though it is clear to him that there is considerable "water" therein. The reason for the auditor's assuming this passive position is because the law gives the directors wide discretionary powers in establishing property values exchanged for securities. Obviously, it is not an auditor's duty to challenge the directors' valuation, but the auditor should point out the correct procedure, and MUST state in his report that the values were established by the directors. In some instances the balance sheet should give this fact just as the notation "Appraised Value" is commonly used.\(^2\)

\(^1\)I.E., if the directors will not accept the auditor's correction.

\(^2\)E.G.--"PLANT PROPERTY, Directors' Valuation." Such a presentation admittedly calls for grit. But it is only by such determination to make statements useful that public auditors will maintain and expand their
Mere rearrangement of such property as machinery or partitions, and so forth, should sometimes be set up in a separate account at cost and written off equitably in the future as a profit and loss item; PROVIDED the rearrangement has effected the economy or purpose for which it was made. If, however, the rearrangement has failed in its purpose, the expenditures should be charged off as a loss, direct to surplus, just as soon as the failure is evident. As stated in section 217, most rearrangements, being caused by the competitive position of a rival etc., should be charged to surplus, unless the original depreciated cost of erecting the asset has been charged to surplus. If the latter theoretically correct procedure has been done, the new erecting costs are proper charges to the asset account.

Interest on borrowed money may be capitalized as a cost of a piece of property if the money was actually used to finance its purchase or construction, and provided the capitalization of the interest charges is "cut off" at the time of starting operations. Naturally, an adjustment for bond premium or discount, if any, will have to be taken into consideration in certain instances.

Property accounts with full details in regard to description, date of purchase, vendor, maker, invoice cost, freight cost, installation cost, repairs, replacements, additions and betterments, provision for depreciation or amortization, et cetera, are entirely feasible and serviceable. Plate 128 shows and explains a type of property ledger card that is useful and easily kept. If property ledgers are installed, they should be kept in agreement with both the asset and the allowance for depreciation controlling accounts. If the plant ledger is installed under conditions where it is impossible to tie-up the plant ledger accounts with the general ledger controlling accounts (which will generally be the case), the differences in the assets and the allowances can be carried on separate cards or the differences may be written off the controlling accounts, whichever may seem to be the better method in the particular case. Within a few years, these difficulties will straighten themselves out, because the "differences" (if retained at the installation of the property ledger) will become fully depreciated, at which time they can be totally eliminated.

<table>
<thead>
<tr>
<th>Asset Controlling Account</th>
<th>Depr. Allowance Controlling Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>475,499.17</td>
<td>193,614.61</td>
</tr>
</tbody>
</table>

Summary of Sub-Plant Ledger Cards

<table>
<thead>
<tr>
<th>No.</th>
<th>Description</th>
<th>Asset Value</th>
<th>Reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>A</td>
<td>$1,646.19</td>
<td>$317.14</td>
</tr>
<tr>
<td>2</td>
<td>B</td>
<td>542.24</td>
<td>59.22</td>
</tr>
</tbody>
</table>

Omissions

<table>
<thead>
<tr>
<th>214</th>
<th>To Balance (separate card)</th>
<th>16,617.54</th>
<th>7,849.43</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total per General Ledger</td>
<td>$475,499.17</td>
<td>$193,614.61</td>
</tr>
</tbody>
</table>

Removal costs, and special installation costs, as when a wall is torn open to allow a boiler to be brought in, should ordinarily be a special expense.

(cont'd) practice. It is no answer to say that "the statement is the client's, --not the auditor's."
403. The Verification Procedure. — In the case of a first audit, the opening balance and entries thereafter in the account must be verified by ample testing, if an unqualified certificate is to be given in respect to the property accounts. If the testing does not disclose any serious errors, the auditor may properly accept the opening balance as being substantially accurate. But if sizable errors are uncovered during the test, the auditor must go deeper into the analysis of the account until he is satisfied that he is justified in calling a halt in his examination of the account.

Furthermore, in a first audit, the auditor should secure a certificate from the attorneys of the client, or if there are none, from the officers in position to know the facts, to the effect that the titles to the property are in order and that the properties themselves are free from all liens and encumbrances except those designated on the books of account. In some instances it is also feasible to prepare for the permanent file of working papers a schedule or map showing the location, size, etc. of the plant land, etc., and of the village houses and lots, if any.

Likewise, a complete analysis, or a test for a considerable period, or a complete "test and scrutiny" coverage, according to the needs or other factors in a given situation, should be made of the surplus accounts, because they may contain entries arising from adjustments (if any) that have been made in the property accounts.

In accounting for a current asset, the auditor must verify the existence of the asset as at the audit date. That is, he must either see the asset, get a direct confirmation of its existence, or otherwise independently establish the fact of its existence. In brief, it is not sufficient for him to simply verify the fact that the asset was purchased and correctly valued. But in accounting for plant property, the auditor is given more latitude. He may rely more largely upon this type of information: i.e., vouchers and inquiry. If, for example, and auditor at the main plant of The Roberts Iron Company, Inc., in Adelphia, Nebraska, saw a proper voucher for a piece of machinery purchased during the year by the company's branch at Pawtuxet, Illinois, he would not deem it necessary to go to Pawtuxet to see that the machinery was actually on hand as at the audit date, nor would he require a certificate of the branch manager. However, it must be pointed out at this time that many leading auditors would very likely verify to some extent the existence of this machinery if it were purchased for the Adelphia factory.

Whenever the authorizations for property additions or alterations are made by the directors, or by a finance or other committee, the auditor should see if the expenditures are in agreement therewith. He should prepare a schedule giving a description of each authorization together with its estimated and authorized cost. Against these figures, he should set up the actual expenditures to date, and the probable costs (secured from plant officials) to complete any unfinished projects. Any unauthorized projects, if significant in amount, should also be reported. This schedule should, of course, be embodied in the audit report, both as a leading and as an interesting exhibit (Plate 130).

1See Appendix C, Sec. 12-41.
2This assumes that the opening balance is not yet fully depreciated. If it is, the auditor should confine his attention to the years set by the depreciation rates; thus if 2% — the last 50 years, if 10% — the last 10 years.
3I.E., the opening balance at the beginning of the current period.
4I.E., the most important changes would be proved by actual inspection.
400. **Explanation and Comments.**—This plate represents ONE type of property ledger card. Naturally, not all cost accountants will feel that all of this data is necessary for their purposes. While this may be true, nevertheless, the maximum useful information should always be made available in this manner.

The best usage calls for the tying-in of the property ledger cards with the corresponding controlling accounts in the general ledger. It must be admitted, however, that sometimes it is not feasible to do so. See also plate 29.
A SUMMARY OF ADDITIONS TO MACHINERY  PLATE 129

The Hamlet Mfg. Co.
Grand Summary of Additions to Machinery
B/S Audit for the Year Ended April 30, 1931

<table>
<thead>
<tr>
<th>Author-Order Verification Number filed?</th>
<th>DESCRIPTION</th>
<th>REM</th>
</tr>
</thead>
<tbody>
<tr>
<td>K-803</td>
<td>Yes Purchase and install 2 Chace planers 36&quot; In Dept</td>
<td></td>
</tr>
<tr>
<td>K-885</td>
<td>&quot;</td>
<td>&quot;</td>
</tr>
<tr>
<td></td>
<td>4 Parker screw hoists 2 each in</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OMISSIONS</th>
</tr>
</thead>
</table>

(15) (15)

401. Explanation and Comments.-- Whenever all new construction projects, etc. must be authorized by the board of directors, or by a finance committee, the auditor should prepare a master schedule (and of course supporting schedules) like the one shown here. The facts thus assembled should be presented, or at least commented on, in the report.

Particular attention is called to the two columns captioned "Verified" and "Not Verified" respectively. This type of arrangement of a schedule summarizes for the auditor's superior the extent to which the verification was carried.

Schedule S is the Master Schedule of all of the property accounts. Plate 130 is similar to (15) mentioned on this schedule.
<table>
<thead>
<tr>
<th>Authorization</th>
<th>Amount</th>
<th>Expended to Date</th>
<th>Total Expended</th>
<th>Estimated Authorization</th>
</tr>
</thead>
<tbody>
<tr>
<td>DF2S</td>
<td>2500</td>
<td>2815.12</td>
<td>2815.12</td>
<td>None</td>
</tr>
<tr>
<td>DF2S and DF1S</td>
<td>12000</td>
<td>11742.31</td>
<td>11903.42</td>
<td>96.50</td>
</tr>
</tbody>
</table>

695400 390816.41 10670.91 401687.32 299000 (5267.32)

SL-a  SL-a  SL-a  SL-b
To S

**AUDIT PROCEDURE**

Authorized, were verified in the minutes of the Finance Committee. See schedule 15.

See schedule SL-a for further details.

Engineer's estimates are given in his letter SL-b.
Additions and Retirements of $500 or over must be authorized by the Maintenance Committee. Those of a lesser amount must be authorized by the respective plant managers.

402. Explanation and Comments.--In many businesses the board of directors, or a finance or other committee, must authorize all plant additions and/or retirements when they are important. The lesser alterations are usually authorized by the Superintendent or Plant Manager in order to secure immediate action.

When these conditions are present, the auditor's report often contains a schedule showing the description of the work, the authorization number, the amount of the appropriation, the amount expended to date, the plant manager's estimate of the cost to complete, and the amount by which the cost will be more or less than the appropriation. In any case; i.e., whether or not this exhibit is presented, the auditor must tie-in these authorizations with his schedules on plant additions. If the cost varies widely from the appropriation, the auditor should ask for an explanation of it.
In verifying the additions to a property account, the auditor must always ask himself, "Does this item replace a worn out item, or does it add to the total number of items already in existence in the plant?" If he does not know the answer to the self-made inquiry, the auditor must stop, figuratively speaking, and find out the answer from the proper person. If the new item is a replacement, the auditor's chief interest must be to see that both the asset account and the depreciation allowance account are relieved of the values assignable to the discarded item. The same sort of question and inquiry must also be made for each credit to the property account, lest the amount thereof be different than cost, or the depreciation allowance be left adjusted, or the new asset be charged to expense. These are very important points for the auditor to cover, because internal accountants are prone to overlook the necessity of making these adjustments for the scrapped property.

Whenever there are no property details, i.e. property ledger cards, the auditor should ask that the client prepare a list of all sizable property items. This list should give a full description of each item, its location, approximate date of purchase and approximate cost. The sum total of all of these costs should approach the balance in the general ledger account. With this information as a basis, the auditor (but preferably the client) can in the future add to it and deduct from it year by year, according to whatever new purchases and retirements are made. The purpose of this record is NOT to catch fraud, but chiefly to keep the property and depreciation accounts as accurate as possible.

It is admitted that without these lists, any large withdrawal of machinery, for example, would come to the auditor's attention on his tour of the plant, or by reason of reduced production, etc. But the point is that individual machines could readily disappear without attracting the auditor's attention. Moreover, in the course of a few years the property accounts, if not kept track of in this manner, might contain many over depreciated items, because the client's accountant has failed to eliminate them from the asset account at the time when the assets were scrapped.

As a part of the verification of property accounts, the auditor must test and scrutinize all maintenance accounts, because experience shows that sometimes, in fact often, assets and extraordinary repairs will be erroneously expensed in these accounts.

Likewise, the auditor should keep track of horses, trucks, and other easily identifiable property items, individually, especially with the idea in mind of checking upon the adequacy of the reserves for depreciation, and size of the amount in the asset account. If this is not feasible, the balances of the asset and depreciation accounts should be divided by the number of units known to exist. This test will show the reasonableness of these averages when checked with common sense and the actual physical appearance of the objects.

404. Retirement of Property—Whenever property is scrapped, sold, or otherwise disposed of, the value in the asset account belonging to this unit must be eliminated by a charge to an adjustment account, such as "Profit and Loss on Retirements of Plant Properties". The proceeds of the sale, or the allowance received for the old unit on the new unit, or the scrap value, as the case may be, should be credited to this same adjustment account. In the

---

1If an asset is renewed, or if it is sold, or if it is placed on the scrap pile and set up on the books at a nett salvage, the auditor is responsible for catching the client's errors. "It must be emphasized that there are two distinct acts whenever there is a replacement of property. The old unit is discarded and a new unit is purchased. Hence the accounting treatment MUST be broken up into these two steps. Any short cuts, such as charging the depreciation allowance for the new unit, are usually incorrect."
next step, the depreciation allowance is relieved of the portion of it which is applicable to this retired property. This is accomplished via a credit to the adjustment account in the amount of a sum computed as follows: 

\[
\text{Value in asset} \times (\text{number of years in service}) \times (\text{rate per annum of depreciation}).
\]

If any expense has been incurred in removing the asset, and so on, this is also chargeable to the adjustment account. The net result of these several entries in the adjustment account will obviously show either a profit or a loss.

The method outlined above, or a similar method accomplishing the same result, is generally known as the unit method of depreciation. That is to say, the total accrued depreciation to date on each individual unit is computed at the time of its retirement; and this amount, no more or no less, is charged to the allowance for depreciation. It should be evident to the reader, after studying Chapter 26, that the unit method of depreciation is always used whenever there is a detailed property ledger.

In those places of business which do not have a property ledger, and they are legion, the unit method of depreciation is not ordinarily used; though it might be if some sort of a record was made (or the original invoices kept) as to the cost and date of purchase of each unit.

In most businesses, therefore, there is usually only a very few property accounts for depreciable items. The most common accounts are, of course, buildings, machinery, equipment and tools, furniture and fixtures, autos and trucks, etc. To these accounts are applied their respective rates of depreciation, say, for example, 2% to buildings, 8% to machinery, and so on. Obviously, the average rate of 8% will, for example, over depreciate those units of machinery whose life is 13 (or more) years, and under depreciation those items of machinery whose life is 12 (or less) years. This discrepancy of over and under depreciation tends to be smoothed out by charging to the allowance the full net cost of each retired asset, irrespective of the amount in the allowance applicable to this particular asset. This the extra charge to the allowance whenever a 12 year asset is charged in full to it (cases of extremely early retirement due to inadequacy, sale, obsolescence, casualty, etc. being adjusted by the unit method) is compensated by an under charge to the allowance whenever a 13 year asset is retired.

A third plan is one whereby the yearly additions to each property account are kept track of by the chief accountant on a separate auxiliary schedule. As soon as each amount becomes fully depreciated, it is charged to the reserve and credited to the asset, even though the physical units are still in existence. In short, whenever a physical asset is retired, the only entry is a credit to Miscellaneous Income or Depreciation Expense for the scrap value. Entries to the asset and reserve accounts are made only when the schedule shows that the additions in a particular year are fully depreciated, or when there is an early retirement due to sale, inadequacy, obsolescence, casualty, etc.

405. Comments on Balance Sheet Presentation.—In general, the items under the main caption of PLANT PROPERTIES should be shown with their respective depreciation reserves. This procedure is recommended although the plant items are often shown net of reserves, especially in condensed balance sheets.

In regard to the advisability of showing the net additions (or better yet the gross figures) to each property account for the period, this procedure is also favored by the writer as being very informative. If this

1The unit method is often used even though the figures are only the estimates of cost, years in service, etc. as furnished by bosses, plant superintendent, and others. 2When correctly viewed, the charge is, of course, NOT an extra charge.
information is not shown on the face of the balance sheet, it ought to be shown as a part of the report comments under the respective property headings.

Expenditures for mere rearrangement of property should be classified under OTHER ASSETS along with organization expense, bond discount, and similar items, rather than under PLANT PROPERTIES.

Although incompletely repaired and work orders may sometimes be kept in the IN-PROCESS ledger, they are NOT goods-in-process inventories under any condition, except where the client is a contractor. If these items are stated as Repair and Work Orders-in-Process, under PLANT PROPERTY, the proper treatment will have been accorded them. This treatment is, of course, based upon the assumption that the orders are to be capitalized when completed. If they are not to be capitalized, they should be expensed or charged to depreciation reserves at once, according to the facts of each case.

Property which is not used by the business, such as extra land, or abandoned land and buildings must be stated separately. Usually such items are more properly classified under the main captions of INVESTMENTS, or under the main caption of OTHER ASSETS, depending upon the facts of the case. Full disclosure must be made.

Returnable containers, bottles, kegs, and the like (often out with customers), must never be listed as inventories, because they are not goods to be sold by the client. Whenever they are charged for and included as accounts receivable, the amount thereof, if sizable, must be deducted from. This is easily done if the records are kept as follows:

```
Accounts Receivable--K  510.00
Sales
Containers--Out
To charge K for goods sold, and
two containers at cost
Cash
Containers--Out
Accounts Receivable--K
To give K credit for cash and one
container received.
```

To ascertain the proper balance of the accounts receivable for the balance sheet, the amount to the credit of the Containers-Out account is simply deducted, i.e. in this illustration $255.00 minus $5.00.

If machinery, or any other property, has been received without the title to it having passed to the client, a notation to that effect must always be made, preferable immediately after the description of the asset. In such cases both the asset, less the depreciation reserve, and the unpaid liability balance may be shown on the asset side of the balance sheet to give effect to the legal aspect of the situation. Another common method is to show on the asset side of the balance sheet the full property value, with its depreciation reserve, and the unpaid balance among the secured current (or possibly fixed) liabilities. On the whole this latter method is preferable, because to all intents and purposes the concern has to meet this current liability if its equity is worth anything. Moreover, the use of a

1Assuming they benefit future operations. 2This happens frequently in the case of wasting asset projects and to ordinary businesses in times of severe depression such as in 1930-34. "Real Estate, Plant and Equipment (including Milwaukee Plant temporarily closed)—at cost $13,980,104.36" (Annual Report (1931) of THE NA H MOTORS COMPANY) Furthermore, it must be recognized that a thing may be abandoned without wrecking it. This is particularly true of machinery, mill property, mines, and mining property; hence the
footnote, or the extension of the net equity as an asset, creates the unfavorable impression of Window Dressing.

406. Balance Sheet Valuation.--As these assets are not to be sold, their going concern valuation is generally cost less natural life depreciation. At times, however, appraisal values, or directors' values (if the property was purchased with stocks and/or bonds) will have to be set up on the balance sheet in accordance with the client's wish. On other occasions the "depreciation" may be on a pure time basis rather than on a "wear and tear" basis, as when a very durable building is erected on land held under a comparatively short lease, or on a unit depletion basis, as when the project is subject to a wasting asset.

407. See Plate 131.2

407a. General Audit Program.
(1) In general capital additions should mean additional or improved property of the type which results in increased productive capacity or reduced costs.

(2) Remembering that one can not always say whether or not an item (e.g., lumber) is a proper capital charge or an expense, the auditor should make careful inquiry into the purpose of each job order. An actual inspection of major additions and retirements, where possible, is always needed.

(3) If the plant assets were acquired from a predecessor company, examine bills of sale and directors' minutes. Ascertain if the total cost is reasonable (if possible). Ascertain how the total cost was allocated to the separate parcels of property. Are the values reasonable?

(4) Items which have a longer life than the main asset to which they are attached must be fully depreciated within the life of the latter, PROVIDED the items are not usable elsewhere.

(5) When rearrangement of machinery or partitions, etc. has taken place, see that the original erecting costs have been taken out of the asset and reserve accounts. Charge the difference AND the "uprooting" costs to surplus. Charge the new erecting costs to the asset account. When the rearrangement is not due to the competitive position of a rival business, nor to general competitive conditions, but to the general policy of the client to seek and adopt new methods, the old costs may be allowed to stand and the new costs may be carried in a separate account (clearly named). This latter account should be written off equitably as a profit and loss item, PROVIDED the rearrangement has affected the economy or purpose for which it was made. If not, charge off to surplus (or better, to Non Operating Losses) immediately.

(6) If interest on money borrowed is capitalized as a cost of an asset, see that the money was actually used to finance its purchase or construction. See that the "cut-off" is at the time of starting operations. Capitalize bond discount or premium, if bonds were floated.

(cont'd) Auditor must be certain that they are taken out of the accounts although actually in existence.

1 Really amortization, NOT depreciation.
2 Operating Profit
3 Idle Plant Expense - Wooster and Columbus $156,230.74
4 Other Deductions $142,661.12
5 Profit before interest earned and federal taxes $222,748.16
6 (The Timken Roller Bearing Company - 1931)
(7) Endeavor to have the client install a property ledger.
(8) In the case of a first audit, test the composition of the opening balance for correctness. The extent of the verification (if permitted) depends in part upon the relative importance of the fixed assets and the importance of the errors found in the tests made.
(9) Secure from the attorneys of the client, or from the officials, a certificate to the effect that the titles to the property are in order and free from all liens except those disclosed in the accounts.
(10) Consider the feasibleness of preparing (or having prepared by the client) a map or schedule showing location, size, purpose, etc. of buildings, plant land, investment land, village houses owned, etc. etc. If one has already been prepared by the client, secure a copy BY ALL MEANS. Use it at every opportunity such as in checking depreciation, insurance, rents, taxes, etc. etc.
(11) Review the surplus accounts for entries arising from adjustments made to property accounts. Pass upon their correctness.
(12) If there is a Plant Committee, prepare a schedule (for the Audit Report) showing what authorizations have been made, the amount authorized, the expenditures actually incurred thereon to date, the estimated costs to complete, the excess of the cost over the authorization (or vice-versa), and similar interesting facts.
(13) In the case of each addition to property, ascertain whether it is a replacement or an addition to the total number of units. If the former, see that there is a proper credit to the asset and debit to the allowance for depreciation for the asset removed.
(14) In the case of each credit to property, do a similar thing as that stated in #13 above, lest the new asset, if any, be charged to expense. See also that the credit is the invoice cost PLUS installation cost. Check each credit entry to an allowance for depreciation account.
(15) Whenever a property ledger is lacking, ask the client to prepare a list of all sizable property items. Give full description, location, approximation date of purchase, approximate cost, etc. Have the client keep the record up to date. Use it to check the correctness of the depreciation rate(s), the existence of the assets, etc.
(16) Review the repair and maintenance accounts for assets expenses.
(17) When the units are horses, trucks, or other easily identifiable items, the auditor should keep track of them individually, as it is then easy to check upon the correctness of the amount in the asset and depreciation accounts. If this is not feasible, the balances of the asset and depreciation accounts should be divided by the number of units KNOWN to exist thereby testing the reasonableness of the averages in the light of common sense and the physical condition of the objects.
(18) In a balance sheet presentation it is ordinarily desirable to show individually the allowances for depreciation. Good practice also favors the showing of sizable net additions (and in special instances the gross additions and deductions) on the balance sheet.
(19) Incompleted repair and work orders are not inventories. Charge to proper asset, allowance, or expense accounts. Remove materials for a new building from inventories.
(20) Property which is not used by the business, such as idle property, extra land, abandoned property, etc. must be stated separately under INVESTMENTS or OTHER ASSETS. Full disclosure must be made.
(21) Exclude from accounts receivable the amount applicable to returnable containers. Treat containers as plant, NOT as inventories.
(22) When an appraisal has been made, give the basis of valuation, the date and the appraiser’s name. Give these facts on future balance sheets until these assets are retired. Show separately net additions made thereafter, and the basis of valuation. Examine the appraisal.
(23) If income bonds are floated, the interest may be paid and capitalized during the period of construction.

(24) Any large expenditures (by contracts let or otherwise) to be made in the immediate future for new construction must be mentioned by a balance sheet footnote. Any cash already set aside for this purpose is NOT a current asset. Include it among the list of plant properties.

(25) Exclude overhead from cost of jobs done for own use except (a) when such overhead has been incurred solely because of this work, and (b) when the shop is working at less than normal capacity.

(26) Intercompany profit resulting from transfers of property should be eliminated. Same procedure for interdepartmental transfers. Insignificant profits may be ignored if desired.

(27) Overhead of the Maintenance Department is a proper charge to the cost of jobs undertaken by it.

(28) In the case of an appraisal, distinguish between capital surplus and earned surplus in allocating the excess of the appraised value over the existing book value.

(29) If properties are purchased for stocks and/or bonds, ascertain the authority for it from the directors' minutes. Describe clearly in working papers how values were arrived at. Give a full disclosure of these facts in the Audit Report. Get all the evidence you can as to what are the true values. Make certain that the directors do not wish to adopt the correct entries. Consider whether or not you are morally and/or legally justified in disclosing this evidence. (Usually not, unless a CLEAR CUT case of fraud.) Ask for permission to be present at future directors' meetings which are to be devoted to the questions of purchasing and valuing new properties. Obviously here is the auditor's best point of attacking this valuation problem since it is then in the flux, NOT after it has taken more or less rigid shape in the form of a minute.

(30) Extraordinary repairs are often chargeable to the allowance for depreciation.

(31) Always keep separate in the working papers the transfers (both asset and allowance accounts) between plants so that the ACTUAL additions, sales and retirements may be ascertained.

(32) Where feasible show on the same audit schedule both the asset and its depreciation allowance in order that nothing may be lost sight of.

(33) When contract work is being paid for according to percentage of completion, the client should secure the architect's certificate on this point.

(34) See that the client's accounting routine is such that no asset could possibly be retired without formal notice of it coming to the chief accountant.

(35) Where a proper composite depreciation rate is being used, retired assets may be charged in full (less salvage) to the allowance account UNLESS retired by obsolescence or other unusual reason. In these latter instances, the allowance should bear only the amount accumulated to date.
### A PROPERTY CLASSIFICATION PLATE 131

**CHART 3**  
Broader Property Classifications Practical to Use for Computing Depreciation.

**LAND**

**RAILROAD SIDING**

**BUILDINGS**

- Construction  
- Plumbing and Sewerage  
- Heating Piping  
- Electric Lighting System  
- Gas Lighting System  
- Sprinkler System  
- Fire Protection Piping  
- Building Elevators

**EQUIPMENT**

- Machine Foundations  
- Steam and Electric Power Plant  
- Power Piping  
- Motors  
- Electric Power Wiring  
- Machinery  
- Furnaces and Ovens  
- Blower System  
- Dust Collector System  
- Plating Equipment  
- Manufacturing Piping  
- Machine Pulleys  
- Machine Belting  
- Main Line Transmission  
- Factory Furniture and Fixtures  
- Store Furniture and Fixtures  
- Scales  
- Trucks  
- Minor Equipment  
- Fire Equipment  
- Standard Tools  
- Special Tools  
- Dies, Jigs and Fixtures  
- Patterns  
- Drawings  
- Office Furniture and Fixtures  
- Time Recorders  
- Telephone System  
- Horses  
- Wagons and Stable Equipment  
- Automobiles  
- Unused Equipment

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407. Explanation and Comments.—This classification is taken from "PROPERTY RECORDS" by H.B.Hall. In this pamphlet he says, "You will note the important bearing which the maintenance policy and the accounting practice in the treatment of maintenance on the books has on the depreciation rate used. Promiscuous rates established for an entire industry, for instance, are both meaningless and dangerous unless there is an absolute uniformity in the accounting practice, maintenance policy, and condition of operation or else the means established by which the deviations from it can be accurately taken into account. These, as well as the property itself, should be studied individually."

"By studying the property we mean its analysis and reduction to elements or groups of elements for which rates can be established and applied in an intelligent manner. The broadest classifications it is possible to use and obtain anything like accurate results are as shown on Plate 3. Those in most cases should also be grouped by buildings, departments and production centers."
REVIEW QUESTIONS

1. What is the most common basis for valuing the plant property of a going concern? Is it a good basis?
2. When may interest and discount be capitalized?
3. What items are properly included under the main caption of PLANT PROPERTY?
4. How would you treat the surplus arising from a revaluation of plant properties?
5. What is a plant ledger? Of what value is it to the client? To the auditor?
6. When may appraisal values be legitimately placed in the books of account?
7. Is it ever advisable to show on the balance sheet the property accounts net of reserves?
8. You are conducting a balance sheet audit of a business which has never been audited before. If you are not to qualify your certificate as to the property accounts, how would you proceed to audit these accounts?
9. Where in the balance sheet would you place a section of land not used by the business? Where would you list abandoned property?
10. What is the auditor's duty in regard to property value established by the board of directors?
11. Give in several paragraphs a full discussion on how to handle returnable containers which are charged for at cost. At a profit.
12. In setting up a plant ledger you find that the details do not agree with the controlling accounts. How would you handle the differences?
   (a) Assume that the details are less than the controlling accounts.
   (b) Assume that the details are greater than the controlling accounts.
13. A concern has an equity of $25,000 in machinery worth $60,000 (cost $85,000 - depreciation $25,000). How would you display these facts on the balance sheet?
14. According to a proper voucher, the firm which you are auditing has purchased a $10,000 machine. Is it necessary for you to see this machine as a part of your verification?
15. What items beside the invoiced cost may be properly included in the cost of a fixed asset?
16. Would you favor showing the gross or net additions and deductions to the property accounts on the face of the balance sheet?
17. The board of directors of the firm which you are auditing authorizes all major property additions and alterations. What effect would this fact have upon your audit procedure and upon your analysis schedules?
18. As at April 30, the audit date, certain repair jobs are incomplete. The value thus far expended is $30,000.00. How would you treat these facts?
19. A certain client of yours hasn't a plant ledger. What would you do about it?
20. What working rule in regard to expensing real capital items has often been adopted by large businesses? Is it good theory? Is it practical?
21. You are at the client's main office in Rhode Island auditing the property accounts of a branch factory in Tennessee. Is it necessary for you to see that the plant properties in Tennessee are really on hand at the audit date? Why?
22. Is it proper to apply the overhead of the maintenance department to the jobs done by this department? Why?
23. In verifying property accounts what major question must the auditor be constantly asking himself? Why?
24. What is the objection to applying factory overhead to jobs done by the factory production departments for internal use? Would you answer be
24. (Cont.) different if there was a good cost system? If the factory was idio?

25. Assume the following: (1) The concern expenses all capital items costing $25 or less. (2) A new machine costing $22 (Material $14, labor $5, and overhead (Dept. A) $3) is build for Dept. D-1J.

Problem: Give the journal entry for applying the overhead, assuming that you are required to adopt this INCORRECT procedure.

26. Why must maintenance accounts be tested and scrutinized as a part of your audit of plant properties?

27. The following table shows the estimated life of the main parts of a cylinder knitting machine. What is the annual rate of depreciation?

<table>
<thead>
<tr>
<th>Part</th>
<th>Cost</th>
<th>Life</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cylinders and dials</td>
<td>$54.30</td>
<td>8 yr.</td>
<td>12 1/2%</td>
</tr>
<tr>
<td>Stop motions</td>
<td>30.00</td>
<td>8 &quot;</td>
<td>12 1/2</td>
</tr>
<tr>
<td>Frame</td>
<td>87.00</td>
<td>25 &quot;</td>
<td>4</td>
</tr>
<tr>
<td>Cains and Parts</td>
<td>132.30</td>
<td>12 &quot;</td>
<td>8 1/3</td>
</tr>
<tr>
<td>Needles</td>
<td>12.00</td>
<td>3 mo.</td>
<td>400</td>
</tr>
<tr>
<td>Sinkers</td>
<td>5.70</td>
<td>1 yr.</td>
<td>100</td>
</tr>
<tr>
<td>Dial jacks</td>
<td>5.70</td>
<td>6 mo.</td>
<td>200</td>
</tr>
<tr>
<td>Total</td>
<td>$348.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

28. Do you agree with the answers given to the following question? If not, why not?

"Question:--Is it proper in any circumstances to capitalize the loss for the first year's operation of a new office building? I do not refer, of course, to carrying charges during construction but have in mind the fact that it usually takes some time to get a new building fully rented and the question is whether this loss could be properly capitalized?

"Answer No.1.--I do not know of any circumstances in which it would be advisable to capitalize the loss resulting from the first year's operations of a new office building.
"It is, of course, often true that for the first year at least the building is not fully occupied and, therefore, the loss in operation results. This loss, however, might continue for the second, third and fourth years and, therefore, this contingency would seem to preclude the arbitrary capitalization of losses at the end of the first, second, third or fourth years. The results of operation should be measured from the date the building was completed and ready for occupancy.

"Answer No.2:-In reply to the question "Is it proper in any circumstances to capitalize the loss for the first year's operations of a new office building?" there necessarily must be a dividing line between preparing to operate and operating, and ordinarily the line falls between the two distinct periods of construction and operating for profit. When there is a no-man's land between the two we have to deal with an intermediate net expense which strictly speaking is neither capital charge nor operating item and this in-between period, of course, is measured not by time but by results.

"In the analogous situation of most new mills, starting-up expense is common, and we believe the customary view is that such expense is a proper charge against profits but not the whole amount against the profit of any one year, the theory doubtless being that starting-up expense benefits all years. Theoretically exact treatment would apportion such expense over the entire life of the project, but that

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28. (Cont.) being unknown the usual practice is to care for it over the fewest number of years which conveniently can absorb it.

"Our suggestion in answer to the specific question therefore would be to mark the first month in which current rental equals current expense as the beginning of the true operating period and treat as a deferred charge, to be written off proportionately over a reasonable number of years, the net expense of the prior partial or partially effective operation.

"Answer No. 3.—This is one of the border-line questions. I always advocate the sound practice of capitalizing as little as possible. Your question goes on to exclude specifically 'carrying charges during construction', which are of course permissible and indeed proper. It is difficult to say that in no conceivable circumstances would a certain course be proper. For instance, I can imagine the erection of a large office building or apartment house in a newly developed section or in a part of the town or city not yet fully developed. In this case the land would be relatively cheap, but the building would be erected with the full knowledge that it was in anticipation of future requirements. It might easily happen that the building was only half rented for the first two or three years, but on the other hand by the time it was fully rented, bringing in a good revenue, the further developments of the district would have added considerably to the land value.

"In such a case as the foregoing, where it is beyond doubt that real estate values are going up and it was forseen that there would have to be losses for one or more years, I think it would be proper to capital-ize the proportion of interest and taxes applicable to the unrented portion of the building, but a case like this would have to be considered on its merits and no hard and fast rule could be laid down. I do not think any portion of operating expenses should be capitalized because they are for the benefit of the tenants and the vacant space will not require any proportionate outlay for operation.

"A question may be raised as to whether the items of interest and taxes and of accrued operating expenses, or, as an alternative, the net less on operating could not be carried forward as a deferred charge. In many cases this might be preferable to capitalizing the amount, as deferred charges are always assumed to be written off within three or five years at the most." ¹

29. What is your opinion of the following? Why?

"As will be observed, the property, plant and equipment of the Company, exclusive of foreign, is carried on the balance sheet at a valuation of $9,700,879.49, after deducting depreciation reserves. As a result of the Company's conservative policy of applying depreciation in previous years, much of the property still in use had been fully depreciated. The rates of depreciation for the year 1931 on certain property were revised and approved by the Company's auditors. Under the former rates of depreciation the Company would have written off $1,282,772.57 instead of $1,030,083.43, as shown in the statement of Income and Surplus. In view of the volume of business and the conservative valuation at which the Company's property is carried, the depreciation provision is considered adequate by both your Company's officers and auditors." ²

THE VERIFICATION OF THE LAND ACCOUNTS

408. The Composition of the Account. Beside the bare cost of a piece of land, any other outlays necessary to improve it, or to change it to a usable condition, or to secure the title, are proper additions to the account (Plate 132). Thus an account may contain attorney's fees, commissions of various kinds, notary and recording fees, proportion of accrued taxes due at the date of purchase, assessments and taxes for such improvements as sewerage, water and curbing, first costs of seeding grass and planting trees, drainage costs, proportion of executives' salaries, 1 cost of dikes, canals, and so on, depending WHOLLY upon the individual case.

Carrying charges, such as taxes and mortgage interest, are sometimes legitimate additions to cost, if the land is being held as a long-time investment, or for future use, or for immediate resale. In the latter instance, this procedure is necessary in order to develop the true profit realized when the land is disposed of. In the case of land held for future use, or as an investment, its future value is supposedly worth to-day's cost plus the cost of carrying the property until such time as it is put into use or sold respectively. If this is not so, the carrying charges must be expensed, or the sound value of the land be shown in parenthesis.

If a piece of land is income producing, or in use, or temporarily or permanently idle, having been in use, these expenditures must not be capitalized. Moreover, in the cases cited above, a halt must be called in capitalizing these charges as soon as it is apparent that they are getting somewhat top heavy; i.e., long before the balance of the account reaches an amount which the business would be fortunate indeed to realize on/if disposing of it. In brief, such charges as have been indicated may be capitalized ONLY if the property is increasing in value AT LEAST as rapidly as the charges are accumulating.2

As cement sidewalks, and the like, are depreciable property, such items must not be entered in the plant land account of a going concern; but they are proper entries in the land account of a dealer in land. For a going concern, the charges should be kept separate and depreciated, such as in the "OUTSIDE IMPROVEMENTS AND APPURTENANCES - NON STRUCTURAL" account, or possibly entered in the building account where they will be depreciated.3

1 Thus if land, purchased for a particular purpose, proves to be poorly adapted to it, the costs of conditioning it to the extent that was supposed to be there originally are losses NOT assets. 2 I.E. taxes and interest.

3 In many instances the auditor should insist that the client prove his position by getting the written opinion of a realtor as to the approximate value of the land. 4 Ordinarily costs of excavation are not chargeable to the land account, whereas filling-in costs are.
In the case of land held as stock in trade, all costs incurred in putting the land in shape for sale including the cost of streets, roads, plans, maps, grading, fees, etc., are capital charges. The total costs may then be prorated to the different lots on a weighted basis, because, obviously, the location of a lot has a vital bearing on its value. Thus if a section of land costs $17,000.00 after all expenditures have been made, and if it is divided into 5 equal sized lots which are weighted in value for location as follows: 3, 3, 2, 1, and 1, the assignable cost prices are $5,100, $3,400, $1,700 and $1,700 respectively.

If a piece of land is bought on which stands a building that must be demolished, the cost of the building and of wrecking it, less the proceeds from the sales of salvaged materials, is a proper capital charge to the land account. The theory is this. The only reason why the purchaser paid for the building, and the net cost of raising it, is because that particular site of land was more desirable for his purposes than was some vacant piece of land selling for the same grand total price.

In summary, all costs whatsoever which secure the title to the land, or which transform the land into condition for use, or which are necessarily incurred, are usually proper charges, in addition to the bare cost thereof.

Credits to the account must, of course, be at cost. If any annual "fructus naturales", such as hay, or indeed wood, if the land was not purchased as a wood patch, is taken from the land and sold, the amounts received are credits to income rather than to the land account. Naturally, an exception is in the case where carrying charges are being capitalized.

409. Sub-Records.—Whenever land is held in different localities, or under different conditions as to mortgage liens, etc. others, a subrecord for each of the parcels is highly desirable. Naturally, the values in the subrecords must be in agreement with the controlling account; and the details recorded therein may be as minute as the client desires, but should always include an unstinted description of the location of all legal documents.

410. See Plate 132.

411. Donated Land.— On some few occasions, the auditor may find that the local community is to give the client the factory site on which the plant is located, PROVIDED certain stipulations are fulfilled, such as to employ an average of 250 men per year for 5 years. At the outset the appraised value of the land, or, on the other hand only $1, may be set up in a separate land account, but with an offsetting valuation reserve of the same amount (especially if the appraised value is used). Or, an account entitled Contingent Donated Land may be opened up in the ledger without any value in it. Only a brief explanation of the contract should be written across the face of the account, including a notation as to where the contract is filed.

If any costs arise from the acceptance of the donated land, such as moving costs, the weight of opinion of leading authorities is that they must NOT be capitalized. In the writer's opinion, however, they may be capitalized if fully disclosed, and placed as an item under the main caption of OTHER ASSETS. The expenditures are not a loss, if at all, until such time as the contract has been broken. Therefore, in the meantime the

1 Or such of them as can not be allocated on a more correct basis.

2 Often erroneously charged to the new building. 3 If the land is carried at $1, the valuation reserve is unessential. 4 In this case the balance sheet might carry the caption, Contingent Donated Land, without being extended at any value whatsoever.
A SCHEDULE ON LAND  PLATE 122

RENFREW, MAC ALLISTER & COMPANY, INC.

Land

Audit for Year Ending December 31, 1929

Schedule L-1

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per G/L 12/31/28</td>
<td>(L-1a) 137149.00</td>
</tr>
<tr>
<td>2/7/29 Waters Realty Corp V-1739</td>
<td>13529.00</td>
</tr>
<tr>
<td>For 1 lot 175' X 400' on Mill St. on which the</td>
<td></td>
</tr>
<tr>
<td>new warehouse is to be built.</td>
<td></td>
</tr>
<tr>
<td>WO-73 Payroll - Improvement of the factory grounds</td>
<td>1329.18</td>
</tr>
<tr>
<td>Materials (trees etc.)</td>
<td>387.93</td>
</tr>
<tr>
<td>V-179 Cement sidewalk installed on John St. by</td>
<td>1517.00</td>
</tr>
<tr>
<td>P. Walker &amp; Sons</td>
<td></td>
</tr>
</tbody>
</table>

Balance per G/L 12/31/29  153912.11
Less - Adjustment #18    60813.63
Adjusted balance 12/31/29 93098.48
(To L)

Audit Procedure

Tax bills covering all of the above property indicate that the client owns the property.
See working paper (L1-a) for a description of the property herein valued at $137,149.00 as of 12/31/28.
The deeds, and the guaranty policies of The Title Guaranty & Trust Company were examined and found to be in order. They cover all of the property.
No examination of the public records was made.

Adjustment #18

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land - Investment</td>
<td>59296.63</td>
</tr>
<tr>
<td>Walks and Roads</td>
<td>1517.00</td>
</tr>
<tr>
<td>Land</td>
<td>60813.63</td>
</tr>
</tbody>
</table>

To transfer the cost of the land on Potter Ave. and on Rose Ave. to the former account, and the cost of the cement sidewalks, being depreciable property, to the second account.

410. Explanation and Comments.—The reader should note in this schedule the care taken by the auditor to verify the ownership of both the old and the new property by means of the tax bills, as well as by the deeds and the guaranty policies. As usual the public records were not examined.
Also observe that any land not connected with the plant should be set up in an account of its own, as an investment.
Although it is customary to charge the cost of sidewalks to the land account, this company has adopted the more accurate procedure of setting up a Walks and Roads account, evidently on the theory that these assets are subject to depreciation whereas land is not.
412. The Verification Procedure.—As stated in the discussion of mortgage receivables, ownership of land is generally evidenced by a deed, nevertheless, the mere fact that a person has a deed to a piece of property does not prove that he owns it. The deed may be void because the property has been transferred. Therefore, the best method of checking up on the true ownership of a piece of property, and upon the liens against it, is to consult the public records in addition to examining the deed, for there is little doubt but that the true owner will immediately have his deed recorded. But, as we have already noted, few auditors are equipped with the legal knowledge required to proceed with this inquiry into the public records. As a result, good auditing practice has resolved itself into this procedure. In special cases, such as in the audit of a land development company, or of a doubtful enterprise, a lawyer’s certificate must be secured, to the effect that all of the property which the auditor has described in his letter to him is the property of the client and free from all encumbrances except those listed. In other cases, the auditor should examine the deed to see that it has been sealed; that it is in the name of the client; that it has been signed properly; and that it has been recorded in the public records. If the title is in the name of another, the client must have an agreement which fully protects him. In such cases the auditor must be careful of his ground because the situation is quite unusual. In addition to this verification, the auditor should see, if possible, the canceled check given in payment for the property, and he should examine the abstract of title or the title guaranty policy, if any, because many titles are apt to be somewhat cloudy. Furthermore, he should examine the tax bills for the description of the property, and for the name of the owner. If the property is known to be rented, the auditor should also see that the rent is being received.

Finally, in the case of land to be received as a donation, the auditor should read and abstract the agreement, so that he may know if the client is living up to the provisions and conditions thereof.

413. Comments on Land and Development Companies.—As a general proposition, all costs (which are not sheer losses) which are incurred prior to

1In all cases where the client constantly retains the services of a lawyer, the auditor must secure a Certificate from him stating that the title to the property are clear and in order, "except as follows." Land and Development Companies cannot be subject to too careful an audit. An approved method of keeping the books of account is as follows: The original purchase may be charged to an "Unimproved Real Estate" account. As the lots are laid out, they are transferred at cost to the "Lot" controlling account, and thence to the "Improved Real Estate" controlling account as soon as buildings are erected thereon. Each controlling account should be analyzed by means of a subledger.

In auditing the accounts, the amount due on accounts receivable must be verified by correspondence; so also amounts due creditors, for land divisions purchased, must be proven by independent inquiry. Likewise, contracts must be reviewed whether they are on land sales or on land purchases. Furthermore, the problem of mortgages and their reduction in the Public Records both on land purchased and on land sold, is one which drives most auditors to despair,
the commencement of operations are allowable capital additions of some sort or other. In the case of land development businesses, the auditor needs to keep in mind that certain charges should go to Deferred Charges to Operations, other charges to the Land account, and still others to the Organization Expense account.

Only those expenditures which add real value to the land should be entered in this account. The following items fall clearly within this category; namely, the grading and paving of streets and sidewalks, the cost of the land used as streets, boulevards, parks, etc., the cost of water and sewer connections, the cost of beautifying boulevards, parks, etc., and possibly certain administrative expenses which had a direct bearing in improving the property. The total of these costs may be pro-rated to the lots on the basis of selling prices.

Most administrative expenses, and preliminary selling expenses, should be carried under Deferred Charges to Operations. As soon as the sales commence, this account must be partly written off as a current expense, say considerably more rapidly than the proportion of the current sales is to the total sales value of the property. This procedure is satisfactory if the sales are brisk enough to sell out the subdivision in reasonably short order. If, on the other hand, the sales begin to drag, the roughly proportional method must be abandoned. In its place must be substituted a policy of writing off just as large sums as are indicated by the need of the particular circumstances, some to surplus if necessary.

The Organization Expense account should contain strictly organization expenses, such as lawyers fees for incorporating, state incorporating fees, engraving costs, etc. The method of handling this account has been treated in chapter 19.

As has been indicated, since land is THE important asset of a land development company, the auditor ought to get the company's attorney to certify that the list of property presented to him by the auditor is the property of the company, and that it is not subject to any further liens than those which the auditor lists. The same procedure must be taken in respect to the lots sold subject to mortgages. If the company hasn't an attorney, the auditor must proceed with the greatest care; and describe his procedure in his report.

The auditor should also keep an independent, and perhaps unknown, record of the property by marking off on a map each lot as it is sold. In this way, his list of unsold lots should tally with the list presented to him by the client. Moreover, the auditor should place on the lots of his map the cost prices and the published selling prices. By using this procedure, the auditor can make certain that for each sale that is made the full cost price is credited to the land account. If a detailed audit is being conducted, this procedure will also assure the auditor that the correct selling price is recorded at the time the sale is entered in the Sales Register. Any variation from published prices must be explained to the satisfaction of the auditor.

414. Comments on Existing Mortgages. If a piece of land is mortgaged by the purchaser after, or when, it is acquired, or, if a piece of land, already (Cont'd) and yet without a complete verification thereof an audit is often only a hollow shell of mere routine checking.

These cost prices may be determined as follows: Cost of Lot X: Cost of the Subdivision; Published Selling Price of Lot X: The Total of the Published Selling Prices of All the Lots Comprising the Subdivision.

There is a practical aspect, however, to the second case; namely, that although the owner is not on the bond and theoretically has no obligation directly for the mortgage, nevertheless, he usually has an obligation in effect. This is especially true if it is a serial mortgage, because in such a case, unless he keeps making the payments of principal as they fall due, the entire amount of the mortgage will fall due, and the property, which may be
subject to mortgage, is taken (with the mortgagee's consent) by the purchaser with the definite assumption of the mortgage as a direct liability, the mortgage may be deducted from the land on the face of the balance sheet. That is, only the net equity of the purchaser in the property gets into his balance sheet as an asset. (In no case, however, should the net equity figure alone be given—the encumbrance, etc. must be shown.) This expresses the legal situation, and is, therefore, the theoretically correct treatment thereof. In practice, however, the land (and/or other property) is generally shown as an asset, and the mortgage as a liability, because this is the true picture of the transaction from the point of view of a going concern.

In regard to the legal status, it is this. In the first instance cited, the mortgagee (because he has released the original mortgagee in favor of the new one) has a general unsecured claim against the new owner for the unpaid balance, if the mortgaged property, when/if sold, does not yield sufficient funds to pay off the mortgage. But, in the second case, the mortgagee can look only to the property and to "the former owner" for reimbursement. Therefore, if the proceeds of the sale of the mortgaged property do not satisfy the mortgagee's claim, the unsatisfied balance is NOT a liability of the new purchaser (i.e. the client).

415. Going Concern and Investment Valuation.—If the entries in the land account of a going concern other than one dealing in land, have been properly handled as indicated herein, the balance of the account is the proper figure to be used on the balance sheet, either as a plant item or as an investment, according to the facts. As with other fixed assets, market prices should have no influence at all. If the bottom should temporarily drop out of the land market, no loss has been realized or is about to be realized by a going concern. Every one is aware of the drop in values. Even a banker does not expect the business to absorb this book loss. Moreover, the law does not require the market value to be taken into consideration in computing the profits available for dividends, and neither does sound accounting procedure. How foolish it would be to record in the annual profit and loss statements first a profit and then a loss on land according to the ups and downs of the land market, whereas the land itself is being used by the concern with no thought whatever of its disposal! (See, however, "A Solution to the Appreciation Problem"—Castenholz (La Salle University Press)

416. Stock-in-Trade Valuation.—In the case of land development companies, the valuation of the land should be influenced by market prices, because the land is stock-in-trade, i.e. a current asset. But as a matter of practice, little can be done in this connection, because there generally is no such thing as reliable market prices by which to value a particular piece of land. The fluctuation of prices applicable to land on John Street may not have the slightest influence on land values on Prince Street. Indeed, one piece of land on John Street might drop in value, whereas another (Cont'd) very essential to the conduct of the business, will be lost by foreclosure.

"So far as the loss of the property itself is concerned, it will be just as real in one case as in the other. Furthermore, the effect of having to make the serial payments is just as real upon the cash position of the company as though the owner were on the bond."—W.A. Staub, Bulletin N.Y.S.S. of C.P.A., Jan. 1931.

1 A mortgagee may refuse to release an existing mortgagor in favor of a new mortgagor because of the former's superior financial status, etc.

2 However, where a change in the nature of a locality has brought a decided and permanent change in value, the auditor may be foolhardy in refusing to recognize the importance of this situation.
piece might gain in value. Moreover, the selling price of unimproved land cannot be used as a basis for valuing the land portion of improved land, because the improvements on the land hinder its ready use for any purpose whatsoever. That is, the value of "free" land is greater than the value of "occupied" land (less, of course, the improvements) because the "free" land can be put to any use that the occupied land cannot be put to without the cost of purchasing and demolishing any improvements.

417. Appreciation Valuation.—If land has been held for a long period, it may be that the property has increased tremendously in value due to the general growth of the population, or for other reasons. In such instances, it is feasible and legitimate to have the land appraised by a disinterested expert, such as an appraisal company. The results may be placed on the books somewhat as follows:

Land

Capital Surplus — Land Appreciation

To record the adjustment necessary to bring the land account up to its appraised value. See file #1719 for appraisal documents of The Bretske Appraisal Corporation of N.Y.

Several reasons can be suggested why such an appraisal may be desirable. For example, if a bond issue, secured by the land and buildings, is to be floated, it may be that the unadjusted property accounts would not display an adequate margin of security for the bonds. If so, it will be necessary for the client to draw up the balance sheet, giving effect to the proposed new financing, on the basis of appraised values in respect to those two property accounts.

Again, for managerial purposes it may be desirable to use appraised values so that when the profit and loss figure (often the Gross Income figure) is compared with the amount of money employed in the business, as indicated by the asset side of the balance sheet, a true answer will be secured as to the gross per cent of profit earned per dollar of assets employed.

Moreover, as the more progressive bankers are taking into consideration many more factors than just the current ratio as a basis for granting a line of credit, a business may feel that its position is immeasurably improved by showing the true facts in regard to its land values.

Finally, it may be interjected here that sometimes a business does not care to show its property at appraised values for fear that the tax assessors will raise the taxes.

418. Depreciation Valuation.—Ordinarily, land is not subject to depreciation, (although its value fluctuates); but in the case of farms and the like, there is often true depreciation which in the aggregate is said to run into hundreds of thousands of dollars annually. This depreciation is due to the fact that certain elements are taken from the soil which cannot be replaced by fertilizers,—at least not profitably replaced by fertilizers. There is then, generally speaking, no reserve for depreciation to be deducted

1Any permanent and major decline in land values due to the shifting of population, business or residential centers, etc. may require recognition. This can be established through a valuation charged to surplus. Declines during depressions, such as in 1930–34, should not be recorded,—unless it becomes permanent. However, many accountants believe such declines in value should be recorded.
from the land account except in special instances.

Another such special instance is to be found in the case of the business and residential property of a mining town whose existence will cease or dwindle to practically nothing as soon as the mine has been drained of its ore. If this single mining project has a more or less definite limited life, as has been assumed, the value of the land of, say a hotel, should be written off gradually to expense, because it will have but little or no value after the mining operations have ceased.

419. Depletion Valuation — Depletion is the term applied to wasting assets. More definitely stated, depletion is applied to those assets, such as minerals, ores, forests, quarries, oil wells, "growing plants yielding recurring crops such as tea, rubber, apples," and the like, which are used up, or exhausted by constantly taking away portions of the asset.

In theory, the computation of the depletion charge, and hence the building up of the depletion reserve, is not complicated. A simple method of getting the unit amount of the depletion charge is to divide the total cost of the project less the residual value, i.e. the probable sales value of the remaining surface land, etc., by the number of units of the commodity that the land is expected to yield. In practice ONE difficulty is to estimate the number of units, such as tons of coal or board feet of lumber, which the land will yield. Naturally, there is a large element of speculation in any such estimation of the total number of units. But, if experienced men are willing to invest large sums of money on the basis of engineers' estimates these same estimates are certainly good enough to be used by auditors and accepted by the client in computing the depletion charges. Of course, practically every depletion charge will have to be charged sometime in the future according as new light is shed on the probable number of the remaining units. The original estimates in regard to a quarry or a forest, for example, ought to be much more accurate (because the units are visible) than those in regard to a coal mine or an oil well. But in either case, the estimates will always be incorrect and the depletion charge will, therefore, have to be changed from time to time.

Besides the straight line method of figuring depletion, there are other "scientific" methods which take into consideration the fact that certain portions of some wasting assets are more costly to get at than other portions, and, therefore, their unit cost values are less than the unit cost values of the accessible portions. Moreover, since these inaccessible portions will not be reached (i.e., needed) until some time in the future, their present values are less than the present values of the accessible portions. With these propositions in mind, some persons have proposed that a mine, for example, should be divided up into blocks, the unit values of which will vary according to the difficulty of getting out the unit and the length of time in the future before the unit will be reached (i.e. needed).

Although there is no doubt but that these are two sound premises for figuring the value of a large wasting asset, portions of which are difficult to get at, nevertheless, comparatively few businesses have adopted this more scientific plan.

At the time of each new estimate of the remaining number of units, two courses of procedure are open; namely, either to adjust the present deple-

1Really amortization, NOT depreciation.
2The student is directed to secure a copy of federal income tax regulations for a more complete discussion of the valuation principles of property subject to depletion.
3In regard to development and carrying charges, the keynote is to charge them as far as possible to SPECIFIC units of production, e.g. a specific well or mine.
tion account and the future depletion rate per unit, or to adjust the future depletion rate.

For example, assume that as of January 1, 1920 a wasting asset cost \$14,000,000 net, and was estimated to have 14,000,000 units. On this basis, a depletion charge of \$1 per unit was made for the first 10 years, during which time 8,000,000 units were used up. Assume further that at the present date, January 1930, a new engineer's estimate shows that there remains 9,000,000 units in all probability.

Under the first plan, which the writer favors, the adjustments would be as follows:

<table>
<thead>
<tr>
<th>Units Mined</th>
<th>8,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units to be Mined</td>
<td>9,000,000</td>
</tr>
<tr>
<td>Total Units (Best Estimate to date)</td>
<td>17,000,000</td>
</tr>
</tbody>
</table>

\[17,000,000 \times \frac{14,000,000 \text{(cost)}}{17,000,000} - \frac{3.82 \text{(new unit price to be applied)}}{3.82} \]

**ADJUSTMENT**

- Depletion Reserve: 1,440,000
- Earned Surplus: 1,440,000

To adjust the depletion reserve on the basis of the new rate:

- 8,000,000 Units Mined
- \$3.82 New Unit Price

\[8,000,000 \times \frac{3.82}{3.82} \text{New Depletion Reserve} \]

\[8,000,000 \times \frac{3.82}{3.82} \text{Present Depletion Reserve} \]

\[\frac{1,440,000}{1,440,000} \text{Adjustment Necessary (decrease)} \]

Furthermore, the new rate to be applied to the current year's depletion, and in the future until the next estimate, if any, is 82¢ per unit.

Under the second plan, no adjustment of the depletion reserve is made, but there would be computed a new depletion rate of 67¢ per unit. This rate will bring the \$8,000,000 reserve up to \$14,000,000 by the time the mine is exhausted of the remaining 9,000,000 units.

**COMPUTATION**

\[9,000,000 \times \frac{3.67 \text{(new unit price)}}{3.67} \text{(remaining)} \]

Finally, it must be emphasized that if a project is very speculative, "exact" methods of figuring depletion must be "thrown to the winds", since the cost of the property must be written off very rapidly in view of the uncertain nature of the enterprise. (It may be noted here that Hoskold's formula is often used to appraise properties.)

420. Balance Sheet Display.—Ordinarily, land, being a fixed asset, is classified under Plant Property. As it is not subject to depreciation, accounts entitled Land and Buildings, or Land and (any depreciable asset)

E.3. A mine contains almost pure ore, but it is extremely difficult and expensive to mine it. Furthermore the ore will last for 75 years at the present rate of mining. But it is the current belief among qualified mining engineers that within 25 years a new and cheap method of separating the mineral from the ore will undoubtedly be found which will make the cost of production in several large and well known mines (not now operated because
should be separated into two accounts, at least for convenience in computing depreciation charges. If any land is being held other than for plant use, it will generally be properly classified as a separate item under the main caption of INVESTMENTS, or possibly in rare instances under Other Assets. If, however, the client is a real estate dealer, the land account may be listed among the current assets, as it is his stock-in-trade.

If a piece of land subject to a mortgage is purchased with out the purchaser's assuming the mortgage as a direct liability to the mortgagee (i.e., the seller is still liable to the mortgagee), it is permissible, and in fact theoretically correct, to show the asset less the mortgage on the asset side of the balance sheet, so that only the equity figure is used as an asset. In practice, however, most auditors set up the land among the assets, and the mortgage among the liabilities, because the assumption is that the mortgage will be paid off.

At the outset, donated land may either be mentioned in a footnote, or it may be entered short among the plant items at its appraised value, or extended as an asset at $1. A fourth method shows the land as an asset, but less its valuation reserve (future capital surplus). As the land and the reserve accounts are always the same in amount, no value can be extended as an asset.

Furthermore, there is no basis for showing the land as an asset at an increasing value proportional to the passage of the time stipulated in the contract. When/if the client fulfills the conditions necessary to acquire (Cont'd) of the cost of separating the mineral from the ore, including also the comparatively low mineral content per ton) so low as to cause the abandonment of the client's mine, just as the client's mine forced these mines into the discard (at least temporarily) when its extreme pure ore vein was discovered.

1. When the land account contains interest, taxes, etc., the balance sheet caption should be as follows:

INVESTMENTS:
Securities (market $xx) $xx
Land - at cost and carrying charges xx xx

2. "Chairman Montgomery: Under ordinary conditions, is it necessary to call attention in the income account of a real estate company to the fact that interest and other charges have been capitalized as part of the cost of carrying properties held for development and/or of the cost of properties in the course of construction?

"Mr. Gray: No. We do not believe it is necessary to state that as it is common practice and generally recognized as such." - "Relations Between Accountants and Bankers", N.Y.S.S. of C.P.A., Nov. 1931, p.19.

(If connection with the problem of capitalizing or expensing taxes and interest as carrying charges on land, it can be definitely stated that land previously used but now temporarily or permanently idle must not be increased in value by such charges. They are debits to profit and loss under the main caption of Non-Operating Expenses and Losses. On the other hand land bought for future use, or speculation should be loaded with these costs up to a reasonable amount. Just what the limit is, is undefinable in a strict way, but there is obviously a time when it is clear that the carrying charges are too heavy.

The purpose of these charges is to show the true cost of the land, either as a basis for bringing it in to the Plant Property accounts, or for figuring the profit or loss on the sale of it. And, this procedure of capitalizing carrying charges is further justified for a reasonable length of time on the basis that if the owner did not believe the land to be worth the cost plus the carrying charges, he would embark on the purchase. However, as indicated, the considerations of keeping exact costs must bow to the practical one of keeping the total cost within reasonable bounds.)
the title, the land can be carried as an asset at its appraised value, and the reserve as a surplus networth item, called perhaps, "Capital Surplus from Donated Land".

420a. Audit Program.

(1) In general, any outlays on land to improve it, or to change it to a usable condition, or to secure the title to it are proper additions to the account, PROVIDED such costs were anticipated.

(2) Carrying charges are sometimes legitimate additions to cost if the land is being held as a long time investment, or for future use, or for immediate resale. In general the increase in value of the property must be at least equal to the increase in carrying charges. If this is not so, the carrying charges must be expensed, or the sound value of the land be shown in parenthesis. The balance sheet MUST state:

LAND (at cost and carrying charges to date)

(3) Exclude carrying charges from land permanently or temporarily idle, having been once in use. Same applies to income producing land.

(4) Exclude cement sidewalks and the like from the account. These are subject to depreciation.

(5) Treat excavation costs as a part of the cost of the building.

(6) In the case of a real estate operator, prorate the original and development costs of the whole subdivision over the individual lots on some such basis as the proposed selling prices.

(7) If land is bought with a building on it that must be demolished, the cost of the building less salvage value, plus the demolition and clearing up costs must be added to the land account, NOT to the new building.

(8) Income from "fructus naturales", such as hay, are credits to income, NOT to the land account, except when carrying charges are being capitalized.

(9) Land contingently donated should not be recorded in the accounts (unless nominally at $1) until title to it has been received. Balance sheet notations of some sort are sufficient. Abstract the contract. See if it is being lived up to.

(10) Transfer costs incurred to move to contingently donated land, may be capitalized (if clearly named under OTHER ASSETS) until such time as the title is secured. At this time, these costs are chargeable to the Donated Surplus - Land account (which credit arises when the Donated Land is debited for its appraised value). These transfer costs are chargeable to surplus as losses, when, as, and if the contract is broken. In this latter case, there is probably an agreement to buy the land at a stipulated price. In any event, record the contract and make necessary adjusting entries.

(11) See deeds to the properties. Examine abstract of title. See that these latter appear regular and have been properly recorded. See in whose name the taxes are made out.

(12) If possible examine the public records for ownership and liens.

(13) If land is income producing, see who gets the income from it.

(14) For new acquisitions, see cancelled checks and vouchers.

(15) In the case of large acquisitions and disposals examine directors' minutes.

(16) Check all sales credits to cash receipts book and sales invoices. See that they agree with the original charges to the account.

(17) When land is purchased subject to a mortgage (guaranteed by the seller) disregard the legal aspect of the situation. That is do not set up merely the net equity acquired, set up the full value of the land as an asset and the mortgage as a liability.

(18) The excess of appraisal value over bookvalue is capital surplus, not earned surplus.
(19) Farm land is subject to depreciation that is chargeable to expense.
(20) Any permanent and major decline in land values due to the shifting of population, business, or residential centers, etc. MAY require recognition in special instances.
(21) Land (not a part of the mine) whose value is tied up with the life span of a mine is often subject to amortization.
(22) For comments on depletion Valuation, see section 419 in the text.
(23) Always separate land from depreciable property, at least in the books of account.
(24) Ascertain if any title insurance exists. Abstract the contents of the policies.
(25) To repeat: (1) in a first audit examine the original entries and the major changes to date; (2) separate land used for operations from land held as an investment, future expansion, or other purpose; (3) secure a certificate that the titles are in order and that no liens exist except those disclosed in the accounts; (4) get date of the latest appraisal and ascertain if the values have been properly recorded; and (5) if the land was acquired other than by cash, ascertain the soundness of the value assigned to it. Examine the directors’ minutes thereon.
(26) See section 407a.

REVIEW QUESTIONS

1. To what account would you charge cement sidewalks? Why?
2. You expend $100 for grass seed to improve the appearance of your plant land. To what account would you charge the cost? Why?
3. Why is it proper to capitalize taxes paid on land held for sale? For future use?
4. Assume that the repairs and maintenance account is very low for the period under audit because the proper repairs are not being made. What entry should the auditor make to reflect this condition?
5. A bill from the city for curbing comes to your desk for proper distribution. To what account would you charge it? Why?
6. On August 9, 1930 you buy a piece of land for $50,000 and assume the tax bill of $800 for the year ending September 9, 1930. What is the proper accounting entry for this transaction?
7. What is the best way to verify the ownership of a piece of real estate?
8. When would you secure a certificate from the company's attorney to the effect that the real estate actually belongs to the company?
9. What other inquiries about the real estate would you insert in this same letter to the attorney?
10. You have had dug a plain drainage canal across a section of your plant land. To what account would you charge it? Why?
11. Why are deeds recorded?
12. What is an abstract of title? What special points would you cover in your examination of a deed?
13. A holds a $12,000 mortgage on B's property valued at $15,000. Unknown to A, B sells his equity to C. Several years later C defaults to A who sells the property for $11,000. Whom (if anyone) will A sue for the $1,000 difference?
14. Can C assume the mortgage in such a way as to relieve B? Why?
15. Why are tax bills given some weight as evidence of who owns the property described therein?
16. The profits of a manufacturing concern are $1,459,817.14. Its land, costing $451,817.57, is now worth only $207,161.93. What amount is available for dividends?
17. How should land held as stock-in-trade be valued? Why?
18. When should a halt be called in capitalizing taxes on land held for investment?
19. Name some of the more common causes why land may appreciate in value.
20. The land and buildings of a business stand correctly depreciated at a net value of $4,518,191.43 whereas their sound value is $5,276,914.58. The business is to float a $2,500,000 bond issue. What arguments might be advanced for bringing on the sound value?
21. To what account would you charge the taxes on a plant building which had been idle for the year? Why?
22. Why is it difficult to get market values for a particular piece of land.
23. The Gross Income of a business is $31,178,145.27; its assets are correctly valued at $10,897,634.81. What rate of profit do the assets earn? Suppose that the balance sheet showed these assets at $9,143,697.28. What is the rate of profit on this basis?
24. Indicate by an illustrative example how the total cost of a tract of land should be spread among the various lots into which it has been divided.
25. A has a deed on a certain piece of property. Does that mean that he owns it? Why?
26. Why is the value of unimproved land greater than that of improved land (less the improvements, of course)?
27. A business purchases a piece of land for $70,000 which is an old building costing an additional $10,000. The building is demolished at a cost of $3000 and yields $1,000 from sales of salvaged materials. What entries are required?
28. Why should an attorney's certificate on the title to the real estate be secured by the auditor on an audit of a real estate business?
29. Why is it poor accounting to keep an account called Land and Buildings?
30. A business is holding $525,000 worth of land received in cancellation of an old account receivable. Where would you place this account on the balance sheet? Why?
31. State four methods of showing donated land, the title to which has not yet been acquired.
32. Does land ever depreciate? Give a full answer.
33. What is meant by depletion?
34. Outline a scientific plan for ascertaining the unit values of a wasting asset such as an ore mine.
35. Present two solutions to the following problem. A mine costs $12,689,071.63 and is estimated to contain as of January 1, 1910 50,000,000 units. Up to January 1, 1930, 17,000,000 units have been mined. At this time engineers estimate that there are 16,000,000 units left in the mine. Give the necessary adjusting entries, if any, as at January 1, 1930.
36. Do you agree with the answer given to the following question? If not, why not?

"Question:"—Will you send some information with reference to the correct way to record on a balance sheet real estate being purchased under an installment contract. Which of the following three ways should it be reported:
36. (Continuation)
(a) The net amount paid as an equity;
(b) The gross purchase price on the asset side of the balance-sheet, less the unpaid balance of the contract with the balance extended as equity owned;
(c) The purchase price of the real estate shown on the asset side as real estate being purchased under contract, and on the liability side the balance of the contract shown as an installment real estate contract payable.

"Answer:-- Such transactions, as are referred to, fall into one of two classes:
1. Those in which the obligation is assumed by the purchaser.
2. Those in which the contract gives the purchaser merely the right to buy the property, but he does not enter into an obligation to complete the transaction.

"In class 1 there is a definite liability and, in my opinion, the proper way to enter such transactions is to show the purchase price among the assets and to set up the unpaid portion as a liability which is reduced as each payment is made. It sometimes happens that this liability is in the form of periodic installments. In that case a portion of it might fall under "current liabilities" and a portion under "deferred liabilities."

"As to class 2, the purchaser has no liability and I think the best way to show the transaction is to place the amounts paid among the assets. This may be done in one of two ways, as indicated by your correspondent under (a) and (b). Those two methods give the same result, but 2 gives full information and I therefore think it is to be preferred to 1."  

37. How would you carry "down payments" or options on land?
38. M Co. pays $300 each on four land options, in order to make certain that the best site will not slip out of its hands. Finally one site is decided upon as the best. How should the option money be treated?

\[1\text{Journal of Accountancy, March 1931, p.232.}\]
421. The Composition of the Account.

If the client has a number of buildings, but especially if they are of different types of construction, there should be a plant-ledger card for each one, controlled in total by the BUILDINGS account in the general ledger. Moreover, it is very desirable that the items generally thought of as being an integral part of the building be segregated in the accounts, at least to the following extent; namely, super-structure, plumbing and sewerage, heating system, foundations, electric lighting system, gas lighting system (if any), sprinkler system, and building elevators. Although such a classification may appear to be too detailed or fantastic to some executives, it is, as a matter of fact, the broadest possible classification practical to use for figuring depreciation.

If the buildings are constructed by contractors, the bills rendered by them are proper charges to the account, after they have been approved by the purchasing department, and provided they do not exceed the contract price authorized by the board of directors. If the buildings are constructed by the client, all applicable material, labor and overhead expenditures, as shown by audited material requisitions, payrolls, etc., are properly capitalized, up to the point of the full completion of the buildings. Executive salaries, architect’s fees, costs of permits, interest paid on money used for the construction work, easements, accident damages paid to workmen, insurance expense, and so on ad infinitum may all (except sheer losses) be legitimate capital charges to the building account if they were incurred for (or during) this construction and BEFORE its completion.

In the case of a building which is being constructed as an addition, the plant being already in operation, the overhead which is charged to the

4At this point the reader’s attention is called to the fact that very frequently buildings are completed upon which some payment is still due. This liability must be set up, as well as the corresponding asset, in order that a proper presentation of the current liabilities may be made, and in order that depreciation may be taken on the full amount of the asset.

As stated heretofore, the amount of an uncompleted construction program is of vital importance to all concerned, hence the auditor must not fail to give the facts in a balance sheet footnote. See also Appendix C, Sec. 12-#3.
job should be strictly limited to those special overhead expenditures which are incurred solely because of this new project. That is to say that no part of the ordinary factory overhead should be absorbed by the new building.

In regard to the capitalization of interest during construction, this procedure is recognized as proper by all leading auditors and accountants, provided the interest was paid or incurred, and provided the money was used for the construction of the building. Of course, at times it is very difficult to say that such and such an amount was borrowed definitely for construction purposes, because it often happens that sums are borrowed and mixed with general funds, from which the construction funds and the operating funds are drawn indiscriminately as needed. Also, by way of illustration, let us say that there is $50,000 in the general cash fund and that $175,000 is borrowed and added to it. If, now, only $105,000 is used for construction, only the interest on $105,000—not on the total $175,000 borrowed—may be capitalized. This is also the proper procedure even if the original $50,000 could be identified as a part of the actual $105,000 used in financing the construction. Of course, if the business started new, the interest cost of the $175,000 would have to be capitalized even though only $105,000 was used, in order that the business may not have to start off with a deficit.²

On occasions an auditor will find that theoretical interest charges have been computed and charged to the BUILDING account, with an offsetting credit to income. This procedure has never been recognized as correct by most auditors for the reason that no actual interest has been paid; because income has been taken up on the books before the enterprise was in operation to earn income; and because income is not earned by construction work undertaken for one's self. In such instances there may be a distinct saving, but never a profit. The profit is realized piecemeal, if at all, during the whole lifetime of the building, to the extent that the actual periodic depreciation charge is less than it would have been if the saving had NOT been effected.

Adherence to these two concepts will result in two buildings of exactly the same construction having different total costs merely because in the one case money had to be borrowed at interest cost, whereas in the other case there was no need to borrow. In reply to the inquiry as to the fairness and sense of such methods, the answer may be stated thus. First of all, interest charges, when the money is borrowed, are cold financial facts requiring entries on the books of account. The interest money having been paid, a debit must be made either to some asset account or to some expense account. The charge could not possibly be to a loss account since value has been received for the expenditure. A primary principle of accounting theory, and also of common sense, is that expense (accounting terminology) is the cost of producing income. As the business has not been in existence to operate, no expense can have been incurred. The only other avenue open is to charge the interest to an asset account, which is, of course, the BUILDING account.

On the other hand, if theoretical interest is computed and entered in the records when none has actually been paid, it is a mere book entry, and not an entry required by a financial transaction. Moreover, each such interest debit to the BUILDING account results in a credit to income, when

1. Interest during an initial idle period should not be capitalized in the case of a building built or purchased for use (or rent) unless it was definitely foreseen that such idleness was inevitable. If justified, discretion must prevail in the amount so capitalized and the auditor would do well to comment on it in his report. So also interest up to time of sale (on property built for sale) is justified if terminated within a few months.

2. This is a special concession.

3. If interest is regarded as a distribution of profits, the results are the same.
no income whatever has been earned. A saving, however, has been effected.

As has been stated, if a business is not allowed to set up theoretical interest as a cost of the new building, it is not put at a disadvantage at all. The business with the larger cost for the building makes the poorer showing in the future, all other factors being equal. Thus, for example, if on A Co's books interest is paid during construction and capitalized, the cost of its building is greater than that of B Co., which did not have to borrow money. As a direct result, assuming all other things equal, A Co's profit will be less than B Co's profit because (1) A Co's depreciation expense is the greater (since its building cost more than B Co's), and (2) it also has interest to pay. This difference in depreciation expense is, of course, exactly the depreciation on the interest which was capitalized as a part of the cost of the building. Furthermore, since A Co's assets will be greater than B Co's assets, a comparison of profits against the money invested in the building will show B Co. in a much more favorable light than A Co. This is illustrated by the following example.

EXAMPLE

(Assumptions)
A Co. and B Co. build identical buildings. It takes 1 year to construct them. A Co. borrows $30,000,000.00 at 5%. B Co. does not borrow at all.

(Solution)

<table>
<thead>
<tr>
<th></th>
<th>A Co.</th>
<th>B Co.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings at Cost</td>
<td>$45,000,000.00</td>
<td>$45,000,000.00</td>
</tr>
<tr>
<td>(less interest, if</td>
<td></td>
<td></td>
</tr>
<tr>
<td>any)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Paid at</td>
<td>$1,500,000.00</td>
<td>None</td>
</tr>
<tr>
<td>5% on $30,000,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Cost 12/31/29</td>
<td>$46,500,000.00</td>
<td>$45,000,000.00</td>
</tr>
<tr>
<td>Net Income before</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest and Depreciation</td>
<td>$4,600,000.00</td>
<td>$4,600,000.00</td>
</tr>
<tr>
<td>12/31/29 to 12/31/30</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Expense</td>
<td>$1,500,000.00</td>
<td>None</td>
</tr>
<tr>
<td>Depreciation at 1 1/2%</td>
<td>$97,500.00</td>
<td></td>
</tr>
<tr>
<td>on $46,500,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>and on $45,000,000.00</td>
<td>$697,500.00</td>
<td>$675,000.00</td>
</tr>
<tr>
<td>Rate of Profit Earned</td>
<td>$2,402,500.00</td>
<td>$3,225,000.00</td>
</tr>
<tr>
<td>$2,402,500.00</td>
<td>$3,225,000.00</td>
<td></td>
</tr>
<tr>
<td>$46,500,000.00</td>
<td>$45,000,000.00</td>
<td></td>
</tr>
<tr>
<td>5.2%</td>
<td>7.1%</td>
<td></td>
</tr>
</tbody>
</table>

In brief, when FACTS alone are recorded, i.e. when theoretical interest is omitted, no one is put at a disadvantage even if two identical buildings are on books of account at different costs. The computation of the rate of earning power which is the correct business index of success should clearly reveal to any one which enterprise is the better off.

In regard to the correctness of capitalizing in the building account the cost of mistakes made on it during its construction period, the answer is that they may be capitalized to a reasonable extent because if they were expensed, the business would start off with a deficit; whereas the facts are simply that the business has a building which cost more than usual, due to the unfortunate errors. However, if the mistakes are sizable, they should be charged to a Deferred Charges (Other Assets) account, instead of to the

1 These Deferred Charges are border line cases. Sheer losses, such as the destruction of a building in process of completion by a fire or a cyclone, etc., are clear cut deficits.
Building account; and thence against surplus as soon as possible. In this connection it should be carefully noted that this procedure represents a considerable concession to the fact that the business is not yet under way. As soon as operations have once started, further mistakes MUST BE treated either as expenses or as losses, depending upon the facts of each case.

Under English law it has been possible to pay dividends during a construction period and capitalize them, but this procedure is not permissible in the United States.

By way of emphasis, it is reiterated that the amount of overhead that should be applied to a project, when the client does its own construction work, is only that additional overhead actually occasioned by the new work. If the ordinary rate of factory overhead is applied to the new undertaking, the obvious result will be to reduce the factory overhead to an unwarranted degree. In other words, true and comparable factory costs will be destroyed if some of the factory overhead is incorrectly applied in this manner to the building account.

Another interesting problem, arising during a period of construction, is the question of the correctness of paying, and hence capitalizing, interest on income bonds the money from which has been used to finance the building. If the directors decide to pay the interest, which they undoubtedly will do in order to maintain the standing of the bonds, their decision is perfectly proper and legal.

If a building is bought by the issuing of capital stock and/or bonds, the value of these securities as shown by current market quotations (if any) is approximately the true cost of the building.\(^1\) Therefore, this is the figure which the auditor must use, or be guided by, if he is asked to present his own personal views.\(^2\) But generally he is not permitted to follow his best judgment. Ordinarily, the board of directors, through its appraisal committee, will have decided upon the values to be recorded in the books of account. As the law sanctions this procedure in the absence of fraud, the auditor's duty is merely to see that the directors' intention is carried out by the accounting entries which the client's accountant has made. Thus it is that the auditor is powerless to act, even though it is obvious to him that there is considerable "water" in the values thus established. It should also be observed in passing that if the current market quotations mentioned supra are above par, a credit to capital surplus would be a proper entry under such circumstances.\(^2\) (But, of course, such instances are rare.) In conclusion, it must be made plain that the auditor's comments in his certificate and/or report on land and buildings must clearly state in those instances that the values were established by the directors, as distinct from the usual comments that the values were verified by vouchers, contracts, etcetera. Such a statement gives the sophisticated reader notice that he must ascertain for himself the true values involved.

The conservative and correct treatment of cash discounts secured for prompt payment of invoices for capital assets, is to credit the discount to the asset account, and not to purchase discounts. Thus, if an invoice for machinery at $40,000.00 is entitled to a 2% discount for prompt payment, the entries would be as follows:

---

\(^1\)On many occasions, however, the market quotations are valueless as an indicator of the true cost. \(^2\)I.E. for a capital stock, but NOT for a bond payable.
This is the correct treatment of the cash discount because it represents a saving. No income whatever has been secured. Moreover, the Purchase Discounts account relates to items bought for sale. In practice, the auditor does not adjust this sort of error if the amount is small, but he should inform the client's accountant as to its proper treatment, so that in the future the entries may be correctly made.

In the discussion of land, chapter 24, it was pointed out that if an old structure on newly purchased land is demolished to make way for a new building, the cost of the old building, plus the wrecking, minus the salvage proceeds received, is chargeable to the land and not to the new building. Also, it should be observed that if bonuses are paid to tenants in order to take up, i.e. cancel, their leases, so that the old building just purchased may be promptly demolished to make way for the new one, these expenditures are also chargeable to the land account. But if, in a totally different situation where the building is valuable and hence not to be destroyed, leases are cancelled through purchase, so that the client may move in promptly into his newly acquired building, the expenditures are chargeable to a separate prepaid rent account. This account must be entirely reduced over the weighted average life of the leases bought up. From then on, the building should be depreciated, but not until then. In the writer's opinion, this is a better procedure than that of charging the expenditures to the building account, and then charging depreciation on the total building cost thus secured, beginning at the date of occupancy by the client.

If a client builds a new structure to replace an old one which it has been using, the remaining value of the old building, i.e. the original cost, plus the wrecking costs, minus the depreciation reserve, minus the salvage received, is not a cost of the new building. It is a LOSS which must be charged to surplus. It is admitted that the owners should include in their computations this loss, incurred in demolishing the old building, when they are figuring to see if a new building would be profitable, but this admission does not alter the fact that for accounting purposes the transaction gives rise to a Capital loss. A new building is not more valuable because another building had to be torn down to make way for it.

If building alterations enlarge or improve a building so as to increase its earning capacity, or cut down its operating expenses, the expenditures thereon are proper charges to the Building account. But if the alterations are confined simply to such changes as the tearing down of old partitions and the erecting in their place of other new partitions of substantially the same value but in a different or same location, these expenditures must be expensed to the extent that they exceed the portion of the reserve for depreciation applicable to the old partitions. However, if the sums involved in such changes are very substantial, they may be temporarily capitalized for a very brief period, PROVIDED the changes increase the earning capacity or

1 Another possible adjustment is to charge the new building with the value of the "old" excavation in so far as it is usable for the new building.
2 I.E. non-operating expense.
3 Quite often a mere estimate.
out down the expense of the business. (Otherwise they are proper charges to surplus.) Such an account if temporarily capitalized should be given some such caption as Building Alterations. As noted, this type of account must be written off very rapidly or immediately if the alterations do not produce the results expected of them. Meanwhile the account must be clearly labelled and listed under the main balance sheet caption of Other Assets.

The writer does not believe that the above generally accepted practice is correct. His opinions are set forth in section 3.17.

In a great many instances the alterations will involve tearing down existing units to be substituted by substantially better or at least more costly units. In such cases the old units must be written off in part against their respective reserves for depreciation, the undepreciated balances being a loss, i.e. a charge to surplus. The auditor must be ever on the lookout for the tendency of some internal accountants to allow the old values to remain in the accounts, and to charge the new expenditures also to the account.

EXAMPLE

(Assumptions)

At the end of its tenth year a storage shed costing $40,000 and having an original life of 20 years is torn down to the extent of $5,000 (cost) to permit the building of a large new addition costing $45,000.

(Solution)

Retirement Entries

Reserve for Depreciation - Storage Sheds 2,500
Loss on Alteration of Storage Shed 2,500
Storage Sheds 5,000

To write off the portion of the dismantled storage shed:

Cost $5,000
10 years' depreciation at 5% 2,500
Loss 2,500

Storage Sheds 45,000
Cash 45,000

To record the cost of the new addition to the storage shed.

1 If any alterations are so extensive that the final structure is more new than old, it is best to close out the account transferring a proper portion of it to a new account. This together with "the new costs" should not exceed the cost (at current market prices of labor and materials) of new property of equal capacity and equal expectations of life in service, less a suitable allowance on account of the second hand portions remaining therein. This same procedure applies to property converted for a different service. (E.g. An Unused dye house is turned into a much needed garage).

2 Ordinarily no adjustment is made for the dismantled portion (say a wall is torn down) of the old building when, for example, a new one is attached to it. But if sizable, the auditor should (in the writer's opinion) insist on the adjustment for the dismantled section. Although not shown in the illustration, the cost of dismantling, less the salvage proceeds, if any, should also be charged to the Loss on Alteration of Storage Shed account.
During a construction period, common credits to the account are (1) discounts, rebates, etc. (2) sales of lumber, rentals and/or other miscellaneous revenue (3) residual or salvage value of materials, small tools, and equipment already charged to the account (4) return premiums on liability and other insurance.

422. See Plate 133.

423. The Verification Procedure.—Whatever was stated in chapter 24 on the necessity of making certain that the land is actually the property of the business, is, of course, doubly true in the case of improved real estate, i.e. land with buildings. If the auditor does not examine the public records himself, he ought to secure a letter from the client's attorney certifying: (1) that the property belongs to the business under audit, and (2) that it is free from all and every sort of lien or encumbrance whatsoever, except those designated. If the client has no attorney, the auditor must rely on other evidence, such as the name, description and amount on the tax bills, the absence of rent expense, the name of the beneficiary in the fire insurance policies, the existence of a real estate mortgage on property answering to the description of the client's, and/or the existence of a deed and an abstract of title, and so on.¹

To reiterate, if a contractor has constructed the buildings, or made the alterations or the improvements, the directors' authorization (if customary), the cancelled checks, the contract, and the creditors' bills if paid for directly by the client for the contractor, must all be seen. In the case of incomplete construction work, the contract must be secured in order to ascertain the size of the project, and hence the amount of the contingent liability. At times the fact that a business has to make such a payment in the near future changes the whole complexion of its current position.²

If the work was done by the client, there will be creditors' vouchers to be examined, if the business had to buy some materials, or secure some service from the outside; but most of the supporting data will be material requisitions, time cards, and overhead computations. These must be tested for accuracy (especially the overhead) and approvals, to the same extent as if they were vouchers from outside creditors. In the case of uncompleted construction, the amount thereof must be certified to by the client for the reason stated above.

Again, the auditor must always find out what each project really is. For example, a material requisition for paint is sometimes chargeable as an expense and sometimes as an asset, depending on the nature of the work. For this reason, some of our leading auditors always make it a point to see the new building, and especially any alteration or improvements, so that they may definitely know the size and true nature of the undertaking. Having seen the physical asset first, the auditor is then able to review the supporting vouchers, requisitions, time cards, and other data, far more intelligently than he otherwise could do.³

If the client's system calls for it, the minutes of the Maintenance and Construction Committee should be abstracted in order to see that the project was authorized. Moreover, the auditor may find it valuable to see if the

¹Such as a CERTIFICATE from the client. ²Even if it will not change the current ratio considerably, the banker, for example, may feel that it is an inopportune time to expend on so large a scale. Moreover, it is NOT the auditor's duty to decide whether or not it is of interest to the banker. The banker will decide that for himself. ³It is undeniably true that one can not always tell from the nature of the item whether or not it is an expense or a capital charge. This fact can not be overemphasized.
A SCHEDULE ON FACTORY BUILDINGS  PLATE 133

Shackleton, Watjen & Co., Inc.
Factory Buildings
Audit for Year Ending Dec. 31, 1929

<table>
<thead>
<tr>
<th>Account Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per our papers and G/L 12/31/28</td>
<td>102768.41</td>
<td></td>
</tr>
<tr>
<td>V-9187 Jones Construction Co.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>New building of 3 rooms - Dept. DKA - to adjoin DX</td>
<td>16843.87</td>
<td></td>
</tr>
<tr>
<td>Estimated portion of the existing building that was demolished to adjoin the 3 rooms</td>
<td>500.00</td>
<td></td>
</tr>
<tr>
<td>W.O.-783 New partitions (not replacements) in Dept. DKA</td>
<td>1083.14</td>
<td></td>
</tr>
<tr>
<td>Materials</td>
<td>543.19</td>
<td></td>
</tr>
<tr>
<td>Labor</td>
<td>452.83</td>
<td></td>
</tr>
<tr>
<td>Overhead</td>
<td>87.12</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1083.14</td>
<td></td>
</tr>
<tr>
<td>V-8197 Jones Construction Co.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slate roof over Dept. DBF, DBG, and DBH</td>
<td>6900.00</td>
<td></td>
</tr>
<tr>
<td>Estimated value of old roof replaced as per Mr. Contra</td>
<td>2800.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes in 1929</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additions</td>
<td>47285.68</td>
<td>4642.83</td>
</tr>
<tr>
<td>Deductions</td>
<td>4642.83</td>
<td></td>
</tr>
<tr>
<td>Balance per G/L 12/31/29</td>
<td>146411.24</td>
<td></td>
</tr>
<tr>
<td>Adjustment #18 (Electric Wiring - To P.L. System account)</td>
<td>3914.02R</td>
<td></td>
</tr>
<tr>
<td>Balance per our balance sheet 12/31/29</td>
<td>141527.15</td>
<td></td>
</tr>
<tr>
<td>To M</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

AUDIT PROCEDURE

1. All invoices were examined.
2. All of the additions were authorized by the Maintenance Committee. (See ML-a), and were within the limits established.
3. The additions to the account were also vouched by an actual inspection of the improvements, etc.
4. The materials and labor on job W.O.-783 were checked out satisfactorily. The overhead is "extra" overhead entirely.

422. Explanation and Comments.-- This exhibit shows the nature of the items properly included under buildings.

Note that in the first case the work was done by an outside contractor, whereas the second job was done by the maintenance department. Also, observe that only the extra overhead was charged on the work done by the maintenance department. In the writer's opinion this procedure is incorrect. The rule applies to OCCASIONAL jobs done by a PRODUCTION department for home use. Accordingly, it would seem that the auditor erred in not making an adjustment for it.
expenditure limit, if any, set by the Committee has been, or will be, exceeded by the actual cost. Indeed, in such cases it is customary for the auditor to present in his report a brief summary of this matter.

If the land and buildings are purchased by capital stock and/or bonds, the directors' minutes will usually show the authorization for this purchase. For this reason the auditor must be certain that he examines the directors' minutes for the authorized amount. In several instances it has been found that high officials have issued more securities, in which they shared, in payment for the newly acquired property than was authorized by the directors.

Moreover, where properties have been acquired for a lump sum, as is usually the case where securities are issued, the auditor must insist that the client break up this amount among the various types of properties by means of some reasonable sort of appraisal. Usually the board of directors will appoint an appraisal committee for this purpose, or possibly it will employ an appraisal company. The auditor's duty is simply to get the CLIENT (he should not undertake to do so himself of his own initiative) to make this appraisal, so that he may present some sort of an intelligible balance sheet. If the auditor is obliged to work out a solution, he should see that it is adopted by the directors and recorded in their minutes. Finally, it is not the auditor's duty to criticize or challenge the directors' appraisal for the legal presumption is that the values established by the board of directors are valid.

Whenever a fire has occurred, the auditor will often find it extremely profitable to review the entries made to record the situation. The correct treatment is, of course, to charge to surplus any portion of the net original cost and the miscellaneous fire expense which are not recovered from the insurance and the salvaged materials. If the fire has occurred near the end of the fiscal period, say within the last week thereof, the auditor will find that in the majority of cases the client's accountant will not have any entries whatever, because no adjustment with the insurance company will have been made. To the auditor, this state of affairs is no excuse for standing idly by. He must insist that estimates be assembled; but if they can not be made, the auditor's certificate must be qualified in this respect. Furthermore, if the estimates are made, the amount to be recovered from the insurance company is not a current asset for it is not available for current purposes. If the account is distinctly labelled and listed under Plant Properties, the facts will have been properly disclosed.

424. The Balance Sheet Valuation—The building will, of course, be valued at cost as shown by the balance in the account, provided the entries have been properly made. Ordinarily changes in the market value of buildings will have no influence at all on their valuation on the balance sheet of a going concern. Theoretically, if the client is a dealer in property, the value of the buildings should be influenced by market prices to the extent of pricing the properties at cost or market, whichever is the lower. But actually there is hardly any such thing as usable, reliable market prices for a particular piece of property. However, in such a situation when market prices are definitely and permanently depressed, a valuation reserve must be set up by the client even though it is but a rough estimate.

If an appraisal has been made by a reputable appraisal company, most auditors will gladly accept these figures, but they will always state in their reports that they are appraisal figures. In addition the auditor will give the name of the appraiser, the date of the appraisal, and other pertinent facts. The method of handling the appreciation surplus is discussed

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1The student should read "A Solution to the Appreciation Problem."—Castenholz (La Salle University Press). "When major price changes in either direction have taken place, recognition should be given to this extraordinary situation."
in the chapter on RESERVES.

425. See Plate 134.

426. Comments on Balance Sheet Presentation.— The building account, with the reserve for depreciation appearing as a deduction, should be shown on the balance sheet under the main caption of Plant Property, provided it is being used as plant property. If a going concern is holding a piece of improved real estate as an investment, that property must be shown as such under the main caption of INVESTMENTS. On the other hand, if a building is held by a dealer in property, it is ordinarily a current asset, being stock-in-trade.

If the appraisal value of a building is being used in the balance sheet, a notation in parenthesis is good balance sheet practice; thus, Buildings (appraised value) — $750,429.18.

When uncompleted construction work exists, it is accurate either to show as an asset the full amount of the contract less the deduction for the unpaid balance, or to set up as an asset the amounts already paid to the contractor. If this latter procedure is adopted, a footnote stating the gross amount of the contract is required. Although it is possible to show under suitable description the full amount of the contract as a fixed asset, and the unpaid balance as a current liability, most auditors do not prefer this method to the other two methods just stated because in their opinion it does not show the facts. The title to the property has not passed from the contractor to the client, the building is not yet in complete existence, nor does the client owe, as yet, the unpaid balance. In the writer's opinion, however, these are not altogether valid objections. These self same clients are apt to be the very ones who on other occasions would insist upon having a certified balance sheet drawn up after giving effect to proposed new financing. In brief, the writer favors the last method when taking the point of view of an outsider, but recognizes that is nothing upon which he could, or should, insist when working for the client. The caption in such cases should read, however, somewhat as follows: Contract Price of Building in Process of Completion.

If the client is doing his own construction work, the expenditures to date may be shown as Uncompleted Construction Work under the main caption of Plant Property, and, if sizable, the amount necessary to complete the project must be stated as a footnote. As stated before, this footnote information is absolutely necessary because of the light it will shed upon the future current position of the business. Obviously, cash will be drawn upon and be replaced not by another current asset but by a fixed asset building, unless some sort of long term financing is to be undertaken.

"My feeling is that where these expenditures are of a sufficient amount to have a material effect on the balance sheet position, or to bring about a material change from the position shown by the balance sheet about to be certified, there ought to be some indication of them. I recognize the difficulty of doing that in a way that is fair both to the reader of the balance sheet and to the client. The client will, in some cases at least, feel that a kind of red flag is being set up which is going to make trouble for him. He feels that he is going to finance it, perhaps, out of a very profitable year he sees ahead, or several years. He feels that he is perfectly safe in his plans. He may feel that the banker who sees the memorandum on the balance sheet will immediately consider it a current liability, if no financing has been arranged for, and that it, therefore, imposes a real hardship on him. Yet I can not help but feel that after all a balance sheet which is presented to a banker or to other credit grantees, is for the purpose of indicating financial position and the possibilities of
428. Betterments on Leased Buildings.—If betterments are made on a
leased building, these expenditures are proper capital charges; but they must
usually be written off by the time of the expiration of the lease, because
the betterments, being real property, revert with the building to the owner.

On some engagements, however, the auditor will find a contract whereby
the owner of the building has agreed to pay for the betterments at their
sound value as at the termination of the lease. In such a case the deprecia-
tion rate is determined by the natural life of the betterments, whereas in the
first case cited, the length of life of the lease must control the deprecia-
tion, or rather amortization, rate of the betterments. Thus, if a lease ends
in 10 years, the rate of amortization of betterments (having a natural life
of 15 years) is 10% per annum, provided the betterments revert gratis to the
owner of the building. But if the owner is to pay the sound value of the
betterments at the termination of the lease, the depreciation rate is 6 2/3% per
annum.

If a new extended lease is secured before the old one runs out, this
fact will generally alter the depreciation rate of those betterments whose
life is controlled by the life of the lease. Thus, in the example supra, if
at the end of 7 years a renewal of 10 more years is secured, beyond the
original 19 years already acquired through the first lease, the entries in
connection with betterments of $10,000.00 would be as follows at the end of
the 7th year.

Amortization of Betterments

Betterments on Leased Buildings

Earned Surplus

To record the current year's expense and to adjust
the betterments account in view of the new additional
10 year lease secured to-day. See file No. 718.

| Original cost of betterments | $10,000.00 |
| 6 years' depreciation at 10%    | 6,000.00   |
| Value now in the account at the end of the 6th year | $4,000.00 |

Original cost of betterments

5 years' depreciation at 6 2/3%    4,000.00
(because the life of the two leases is 20
years which exceeds the life of the betterments,
i.e. 15 years.)

Adjusted value at end of 6th year | $6,000.00 |
This year's depreciation at 6 2/3% | 666.67   |
Correct value at end of 7th year  | $5,333.33 |

(Cont'd) discharging financial obligations, and while in a case of this kind
the obligation may not yet be one legally contracted, it is one practically
contracted.

"There is the possibility of discontinuing the construction in times
like these, although sometimes it is just in times like these that it would
pay to go ahead with it, because of lower costs. It may not, therefore,
prove to be a 100 per cent liability. I can not help feeling, however, that
if we are not already at this point where the general practice is to put
some kind of notice on the balance sheet of a situation of that kind, we are
not very far away from the time when it will be recognized as the best
<table>
<thead>
<tr>
<th>Buildings</th>
<th>Audit for Eleven Years Ending Dec. 31, 1927</th>
<th>Schedule G</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 DK1A</td>
<td>Total 12/31/26 1927 1925 1924</td>
<td>342.19</td>
</tr>
<tr>
<td></td>
<td>Additions in 1927 Sec G11-a 3147.76</td>
<td></td>
</tr>
<tr>
<td>1 DK2A</td>
<td>Total 12/31/26</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Additions in 1927</td>
<td></td>
</tr>
<tr>
<td>2 DF2B</td>
<td>Total 12/31/26</td>
<td>614.41</td>
</tr>
<tr>
<td>3 DF3B</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Deductions 1927 G11-a 1075.002</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total 12/31/26 854891.59 1022.68 301091.05 1416.12</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net additions 1927 1607.43 G10-a G9-a 66-a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total 12/31/27 870963.02</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Our figures 854891.59 1607.43 870963.02
Per Books 770377.54 13641.97 783019.51
Adjustment #38 84613.95 3429.55 67945.51

<table>
<thead>
<tr>
<th>RESERVE FOR DEPR</th>
<th>1927</th>
<th>1926</th>
<th>1925</th>
<th>1924</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 DK1A Total 12/31/26 21655.67 2395.12 2395.12 2392.55</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additions in 1927 23.54</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 DK2A Total 12/31/26 8279.25 2394.07 2394.07</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additions in 1927 2394.06</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 DF2B Total 12/31/26 7674.32 1036.15 1030.02 1023.68</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additions in 1927 1036.15</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 DF3B Total 12/31/26 8548.51 770.39 770.39 770.39</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additions 1927 770.39</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Charges 1428.78R 671.64R</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total 12/31/26 80996.38 17489.55 14256.17 11169.58</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net additions 1927 17202.14</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total 12/31/27 98198.52</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Our figures 80996.38 17202.14 98198.52
Per Books 64616.53 15482.41 80362.04
Adjustment #38 16177.75 1716.73 17893.48

1. Rate 1 1/2% per annum
2. " 2 " "
3. " 2 1/2% " "
   For the audit procedure, see the Program
### Calculation of Reserves

<table>
<thead>
<tr>
<th>Year</th>
<th>1923</th>
<th>1922</th>
<th>1921</th>
<th>1920</th>
<th>1919</th>
<th>1918</th>
<th>1917</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>10715.81</td>
<td>3287.15</td>
<td>145329.18</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>OMissions</td>
<td>0</td>
<td>579.68</td>
<td>50614.00</td>
<td>30615.54</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Values</td>
<td>170320.60</td>
<td>75342.88</td>
<td>49976.54</td>
<td>515.80</td>
<td>53901.15</td>
<td>30815.54</td>
<td>170329.95</td>
</tr>
<tr>
<td>G7-a</td>
<td>G6-a</td>
<td>G5-a</td>
<td>G4-a</td>
<td>G3-a</td>
<td>G2-a</td>
<td>G1-a</td>
<td></td>
</tr>
</tbody>
</table>

### Calculation of Buildings

<table>
<thead>
<tr>
<th>Year</th>
<th>1923</th>
<th>1922</th>
<th>1921</th>
<th>1920</th>
<th>1919</th>
<th>1918</th>
<th>1917</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>2309.61</td>
<td>2229.24</td>
<td>2229.24</td>
<td>2229.24</td>
<td>2204.64</td>
<td>2179.94</td>
<td>1069.97</td>
</tr>
<tr>
<td>OMissions</td>
<td>1197.04</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Values</td>
<td>1023.66</td>
<td>1023.66</td>
<td>1018.08</td>
<td>1012.28</td>
<td>506.14</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GL-a</td>
<td>G7-a</td>
<td>G6-a</td>
<td>G5-a</td>
<td>G4-a</td>
<td>G3-a</td>
<td>G2-a</td>
<td>G1-a</td>
</tr>
</tbody>
</table>

### Explanation and Comments

425. Explanation and Comments.— On this audit the accountant was called upon to audit the asset and the reserve accounts from 1917 to date, i.e. 1927 inclusive.

This exhibit is a summary sheet, the asset values being supported by eleven subschedules (G1-a to G11-a inclusive) which show the nature of the items allowed by the auditor for each year on each of the separate buildings. Upon this basis the reserves are computed on this summary sheet at their respective rates per year.

Note that in 1927 a charge of $1428.78 was made to the reserve account being the amount applicable to the reitred asset (costing $1,428.78), which is reflected in the asset section at the top in the net deductions of $1,076.00.
A MASTHER SCHEDULE OF BUILDINGS (With Depreciation Reserve) (2d TYPE) PLATE 135

Foley, Atkins & Foley
Buildings, and Reserve for Depreciation 1-17-24

<table>
<thead>
<tr>
<th>Rate 2%</th>
<th>From Schedules M-1 to M-11</th>
<th>Building Account</th>
<th>1913 1914 1915</th>
</tr>
</thead>
<tbody>
<tr>
<td>1913 Additions</td>
<td>M-1 467814.29</td>
<td>4678.14 9356.28 9356.28</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>2 20145.67</td>
<td>201.44 402.88</td>
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</tr>
<tr>
<td>15</td>
<td>3 8964.21</td>
<td>1407.49 89.64</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>4 807.02</td>
<td></td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>5 381.17</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>6 14761.98</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>7 381.61</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>8 402.12</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>9 601.19</td>
<td></td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>10 708.45</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>11 516373.20</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total 12/31/23 516373.20

Yearly Depreciation Charge 4678.14 9357.72 9848.80
Reserve Balance 1/1/ 4678.14 14235.86
Debits to the Reserve Reserve Balance 12/31/ 4678.14 14235.86 24064.66

427. **Explanation and Comments.**—In this schedule the auditor has used the distributive method, commonly employed in an insurance register to distribute the prepaid insurance.

Note that the additions to the building account were analyzed on schedules M-1 to M-11 inclusive.

Also, note that the "Debits to the Reserve", if there were any, would be developed on M subschedules.
### RIGHT SIDE OF PLATE 135

<table>
<thead>
<tr>
<th>1916</th>
<th>1917</th>
<th>1918</th>
<th>1919</th>
<th>1920</th>
<th>1921</th>
<th>1922</th>
<th>1923</th>
</tr>
</thead>
<tbody>
<tr>
<td>9356.28</td>
<td>9356.28</td>
<td>9356.28</td>
<td>9356.28</td>
<td>9356.28</td>
<td>9356.28</td>
<td>9356.28</td>
<td>9356.28</td>
</tr>
<tr>
<td>402.88</td>
<td>402.88</td>
<td>402.88</td>
<td>402.88</td>
<td>402.88</td>
<td>402.88</td>
<td>402.88</td>
<td>402.88</td>
</tr>
<tr>
<td>179.28</td>
<td>179.28</td>
<td>179.28</td>
<td>179.28</td>
<td>179.28</td>
<td>179.28</td>
<td>179.28</td>
<td>179.28</td>
</tr>
<tr>
<td>3.82</td>
<td>7.64</td>
<td>7.64</td>
<td>7.64</td>
<td>7.64</td>
<td>7.64</td>
<td>7.64</td>
<td>7.64</td>
</tr>
<tr>
<td>4.02</td>
<td>8.04</td>
<td>8.04</td>
<td>8.04</td>
<td>8.04</td>
<td>8.04</td>
<td>8.04</td>
<td>8.04</td>
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<tr>
<td>6.01</td>
<td>12.02</td>
<td>12.02</td>
<td>12.02</td>
<td>12.02</td>
<td>12.02</td>
<td>12.02</td>
<td>12.02</td>
</tr>
<tr>
<td>7.08</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

9952.51 9974.65 9996.53 10137.96 10289.40 10297.24 10307.27 10320.36

24084.66 34037.17 44011.82 53998.35 64135.31 74425.71 84722.95 95030.22

34037.17 44011.82 53998.35 64135.31 74425.71 84722.95 95030.22 105350.58
Furthermore, the new rate of depreciation in the future will be 6 2/3% per annum.

If, the betterments to the leased property are of small value, they are sometimes placed on the balance sheet under the main caption of Deferred Charges. But as a rule, it is more satisfactory to set them up under the main caption of Plant Property.

The verification of the additions to the account should be made in the usual manner, by an examination of vouchers, work orders, contracts, minutes, the physical property, and so on. The credits, on the other hand, will be governed by the length of life of the lease (which, by the way, the auditor must examine and abstract for his permanent file of working papers) or by natural life of the improvements, if the life of the lease exceeds that of the asset. Retirements must be credited to the account at depreciated cost.

The values in the account, if properly handled, are acceptable for the balance sheet because market prices have no bearing on the situation.

429. See Plate 136.

430. See Plate 137.

439a. Audit Program Comments.

(1) Each building of different construction should have its own special rate of depreciation.

(2) In establishing the depreciation rate take into consideration such factors as: (a) the number of hours per year the machinery in the building is being used; (b) the type (light or heavy) of machine work being performed therein; (c) the adequacy of the client's repair and maintenance policy (assuming any deficiency is not taken up by a Reserve for Accrued Repairs and Maintenance; (d) the injurious effect of special outside influences (such as extreme nearness to a railroad having a dense freight traffic; (e) the general quality of the materials and workmanship in the building and its foundations as evidenced by present visual defects; (e) etc. etc.

(3) Endeavor to get the client to segregate the building equipment into such accounts as: heating system, sprinkler system, plumbing and sewerage, elevators, etc. Apply individual rates of depreciation to each account.

(4) If a building is built by a contractor, see the authorization of it by the Plant Committee. Compare the authorized amount with actual price paid. Review the contractor's contract. Check account entries to approved vouchers. If the building is finished, ascertain if the client has unpaid installments still due. Set these up, if not already on the books.

1I.E. to the end of the first 15 years. The depreciation rate for the last 5 years will depend upon the type of new assets bought, the possibility of renewing the lease, and the like.

It may be interjected here that alterations by a landlord to suit a tenant the former should keep them in a separate account and write them off rapidly or over the term of the lease, if any. The danger is that the several alterations for successive tenants will be capitalized without the cost of the former alterations being removed from the account.

Again, it is worth while to repeat that although the capitalizing of rehabilitation and/or remodeling costs of run down secondhand property is amply justified, it is NOT proper to capitalize the rehabilitation and/or remodeling costs of one's own run-down and/or obsolete, inadequate property.
A SCHEDULE ON EQUIPMENT AND FIXTURES  PLATE 136
GOOCH FURNITURE PLANT
Equipment and Fixtures of Factory Buildings
Audit for Year Ending April 30, 1929

<table>
<thead>
<tr>
<th>Dr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bal. per our papers and per G/L 4/30/28</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>V841 Robertson &amp; Sons</th>
</tr>
</thead>
<tbody>
<tr>
<td>new plumbing in Dept. #5 room 7</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>V890 Jacobs and Wheeler</th>
</tr>
</thead>
<tbody>
<tr>
<td>new sprinklers in Dept. #5 room 7</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>W047 Removed defective heating system in</th>
</tr>
</thead>
<tbody>
<tr>
<td>room #2 Dept. 4</td>
</tr>
</tbody>
</table>

New heating system installed
- Labor | (460.19)
- Material | (431.07)
- Overhead | (95.17)

Bal. 4/30/29 per G/L and per Balance Sheet | 14771.36
(To H)

Audit Procedure

All invoices and vouchers were examined and the nature of the jobs were found by actual inspection to be proper capital additions. The overhead on W0-47 is "extra" overhead.

429. Explanation and Comments.—This exhibit shows the nature of the items properly included under this caption.

As the equipment and fixtures of a building depreciate much more rapidly than the building proper, the setting up of an account for these items is a small but excellent step towards greater accuracy in the computation of depreciation. As a matter of fact, the broadest property classification practical to use for computing depreciation is as follows:

1. Construction
2. Electric Lighting System
3. Sprinkler System
4. Heating Piping
5. Plumbing and Sewerage
6. Building Elevators

See also "Auditing and Accounting Handbook", Kilduff, p.261.
A SCHEDULE ON LEASEHOLD IMPROVEMENTS  PLATE 137

ROBERT CUSHMAN & BROS.
Leasehold Improvements
December 31, 1929
Schedule II

<table>
<thead>
<tr>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td></td>
</tr>
<tr>
<td>Additions</td>
<td></td>
</tr>
<tr>
<td>and amortizations in 1926 per our Working Papers</td>
<td></td>
</tr>
<tr>
<td>1926 (1/5)</td>
<td>7500.00</td>
</tr>
<tr>
<td>1927 (1/4)</td>
<td>8000.00</td>
</tr>
<tr>
<td>1928 (1/3)</td>
<td>3000.00</td>
</tr>
<tr>
<td>1929 (current amort. expense) none</td>
<td>4500.00</td>
</tr>
<tr>
<td>Balance Dec. 31, 1929 per G/L</td>
<td>18500.00</td>
</tr>
<tr>
<td>Adjustment #42</td>
<td></td>
</tr>
<tr>
<td>Dr. - Surplus</td>
<td>4500.00</td>
</tr>
<tr>
<td>Cr. - Leasehold Improvements</td>
<td>(4500.00)</td>
</tr>
<tr>
<td>Final Balance Dec. 31, 1929</td>
<td>0</td>
</tr>
</tbody>
</table>

Audit Procedure

The company holds a 5 year lease on the Chattanooga, Tenn. plant from Jan. 1, 1926 at a yearly rental of $15,000.00.

As the plant is being moved to Rome, Ga. in Jan. 1930, the balance of this account $4500.00 has been written off to Surplus by adjusting entry #42. The amortization credit in 1929 of $4500.00 is computed as follows.

7500 (1926 additions) X 1/5 = 1500.00
8000 (1927) X 1/4 = 2000.00
3000 (1928) X 1/3 = 1000.00
4500.00

450. Explanation and Comments.---This schedule illustrates the point that the depreciation rate of an asset may be determined by the length of a lease rather than by the length of its own natural life.

Note that the balance of the account was charged off to surplus. It is improper to treat this amount as a cost of acquiring the plant in Rome, Ga.

Also, note that when an auditor's adjustment is made at the end of a schedule, the best method is to show the details of the adjustment. The auditor could have written merely

Balance Dec. 31, 1929 per G/L 4500.00
Adjustment #42 4500.00
Final Balance Dec. 31, 1929 0

In this latter case, it would be necessary for one to "chase up" adjustment #42 on the Auditor's Adjustment Journal in order to get a complete picture of the adjustment.
(5) If a building is built by the client, see the authorization of it by the Plant Committee. Check account entries to approved Creditors' voucher, material requisitions, payrolls, etc. in the same manner and same extent as purchases of fixed assets from creditors. Permit the capitalization of overhead actually incurred for and during the construction and BEFORE its completion. No element of profit can be absorbed. Do not permit losses to be capitalized as when there is a fire not covered by insurance. If normal operations are also being carried on concurrently do not lessen the factory overhead by absorbing some of it into the construction costs. Interest actually incurred FOR and DURING the construction may be capitalized. Dividends must not be paid and capitalized.

(6) Materials in "Stores" purchased for new construction must be included among plant properties, NOT among inventories.

(7) If a building now in use by the client is demolished to make way for a new one, the depreciated cost of the old building (less salvage value) plus demolition and clearing costs are losses, NOT costs of the new building.

(8) When partitions and whole sides of buildings are demolished in an expansion or improvement program, the depreciated cost of these items (less salvage value) plus demolition and clearing costs are losses, NOT costs of the new building.

(9) A building converted to a new use should not stand in the accounts at more than the cost of erecting a structure suited to this new use.

(10) When new construction is in progress, disclose on the balance sheet the extent of the full program.

(11) Secure a certificate from the client's attorney (or if none, then from the client) stating: (1) that the property belongs to the client; and (2) that it is free from all and every sort of lien or encumbrance except disclosed in the books of account.

(12) Use tax bills, insurance policies, absence of rent expense, mortgages, etc. as evidence tending to verify the client's ownership.

(13) If feasible, examine the public records for existence of liens, etc.

(14) Examine personally each major addition or alteration. Compare your estimate of cost with the amount entered in the account. Check out to your satisfaction any large differences. Ascertain if the alterations are true capital additions.

(15) Whenever a fire has occurred, especially in the last month of the fiscal period, the auditor must carefully review the accounting treatment given to record the situation. The assets destroyed must be removed from both the asset and depreciation accounts. Never set up the insurance claim as a current asset if the plant is to be rebuilt.

(16) When major price changes in either direction have taken place, recognition should be given to this extraordinary situation.

(17) Buildings not used for operations must be stated separately, such as under the main caption of INVESTMENTS.

(18) If permanent additions are made to leased property, ascertain if the life of the lease controls the rate of depreciation. Abstract the terms of the lease.

(19) Repairs to a building bought in a run-down condition may be capitalized.

(20) Verify the authority given for any large disposition of buildings.

(21) Ascertain if any charges to the account are based upon appraisal values. State fully on the balance sheet. See section 407a -$22. See if credits arising therefrom are properly credited to Capital and Earned surpluses.

(22) Audit all credits to the account to see if the assets disposed of have been taken out at the amounts originally charged into this account.
"Examine plant orders, authorizations, property records, and also copies of invoices of miscellaneous sales as a means of determining if capital assets have been dismantled, destroyed, transferred out, sold or otherwise disposed, but not credited to the property accounts."

(24) See that for each credit to the asset account there is a debit to the allowance for depreciation, if proper. See that the amount charged to the reserve is correct. Reverse this procedure in auditing the debits in the allowance account.

(25) If any property was acquired other than by cash, verify the reasonableness of the values used. See directors' minutes.

(26) See section 407a.

REVIEW QUESTIONS

1. When is it proper to capitalize the interest which is paid during a construction period?
2. A piece of improved real estate is bought with a $1,000,000 (par value) worth of capital stock. The board of directors instructs you to prepare the proper entries for their inspection and approval. Describe what you would do.
3. What is the correct treatment of cash discounts taken on capital items?
4. Why must the auditor examine all contracts made on new construction projects?
5. Does it put a company at a disadvantage to forbid it to capitalize as interest an amount which is never paid out as such? Why?
6. What precautions must the auditor take when the client has had a recent fire?
7. What overhead should new building construction work bear when it is done by the business for itself?
8. How should a dealer in property value it for balance sheet purposes? Suggest a practical way of valuing it even though there is no such thing as a reliable market price for a particular piece of property.
9. A business constructs a building for itself. What kinds of supporting date would you expect to see?
10. What is the proper basis for valuing the plant property of a going concern? Why?
11. Is interest which is paid on income bonds during a construction period a proper capital charge? If so, to what account?
12. Is it proper for a client to figure and capitalize the interest on money used in construction if the money was not borrowed? Why?
13. During the construction of a building, a mistake is made. It cost $15,000 to rectify the error. Should the client capitalize this $15,000? Why? How?
14. Is it proper during a construction period to declare dividends and hence capitalize them? How?
15. Would you capitalize the damages paid by a client to the family of a workman who was killed during the construction of a building by and for a client?
16. What is your opinion of the following? Why? "When property is converted for a different use or when the cost of the renewals to be made to any unit of equipment will constitute the major portion of its value as renewed, the equipment when taken out of service, shall be considered as retired . . . . and for the purpose of this classification the renewed equipment shall be considered an addition and the appraised cost thereof
16. (Cont.) shall be included in the account appropriate for the cost of the equipment. In no case shall the charge for the renewed equipment exceed the cost (at current market prices of labor and material) of new equipment of similar type, equal capacity, and equal expectation of life in service, less a suitable allowance on account of secondhand parts remaining therein."—Interstate Commerce Commission.

17. What is your opinion of the following?
"On account of the extraordinary conditions existing in the automobile industry, the management felt it was necessary to consolidate our activities and forces into a more compact position. In order to accomplish this, the Milwaukee plant, has been temporarily closed, and hereafter this line of cars will be manufactured at the Kenosha Plant." (1931 Annual Report, Nash Motors Co.)

Net Income for Year $xx
Direct Credits to Surplus (Net) $xx
Less: To write down Milwaukee
Machinery and Equipment accounts
(Plant temporarily closed) 254,050.75 xx
431. General Discussion.

In a poor accounting system there will be only one Machinery and Equipment account (Plate 138). When such is the case, the client will have applied a single flat rate of depreciation to the whole account. As machine foundations, machinery of all types, belting, hand trucks, shafting, cables, motors, power house equipment, hand tools, machine tools, dies, piping, and so on, may have been charged to this one account, the single rate of depreciation used by the client may represent nothing more than a "wild guess". Therefore, when the auditor is confronted with such a nightmare, which is more often than not, he should use whatever influence he has to get the machinery and equipment separated into proper classifications. Meanwhile, he will have to content himself with depreciation estimates based upon a list of the sizable items prepared for him by the client. For example, assume that this account in a hotel stands at $207,891.42, and that it is estimated by the client to consist of the following items.

<table>
<thead>
<tr>
<th>Client's Estimated Cost Value</th>
<th>Auditor's Rate of Deprec.</th>
<th>Auditor's Estimated Deprec.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Laundry Machinery $xx</td>
<td>.10</td>
<td>$xx</td>
</tr>
<tr>
<td>Pipes xx</td>
<td>.05</td>
<td>xx</td>
</tr>
<tr>
<td>Refrigerating Mach. xx</td>
<td>.10</td>
<td>xx</td>
</tr>
<tr>
<td>Power Plant Mach. xx</td>
<td>.08</td>
<td>xx</td>
</tr>
<tr>
<td>Boilers xx</td>
<td>.07</td>
<td>xx</td>
</tr>
<tr>
<td>Elevators xx</td>
<td>.07 1/2</td>
<td>xx</td>
</tr>
<tr>
<td>Dynamos xx</td>
<td>.10</td>
<td>xx</td>
</tr>
<tr>
<td>Electric Fixtures xx</td>
<td>.07 1/2</td>
<td>xx</td>
</tr>
<tr>
<td>(Other specific items) --</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Miscel. to Balance xx</td>
<td>.10</td>
<td>xx (Yearly Deprec)</td>
</tr>
<tr>
<td>Balance in Machy &amp; Equip. Account $207,891.42</td>
<td>$19,071.83</td>
<td></td>
</tr>
</tbody>
</table>

431a. Audit Program.

Review Questions.

431. General Discussion:-- In a poor accounting system there will be only one Machinery and Equipment account (Plate 138). When such is the case, the client will have applied a single flat rate of depreciation to the whole account. As machine foundations, machinery of all types, belting, hand trucks, shafting, cables, motors, power house equipment, hand tools, machine tools, dies, piping, and so on, may have been charged to this one account, the single rate of depreciation used by the client may represent nothing more than a "wild guess". Therefore, when the auditor is confronted with such a nightmare, which is more often than not, he should use whatever influence he has to get the machinery and equipment separated into proper classifications. Meanwhile, he will have to content himself with depreciation estimates based upon a list of the sizable items prepared for him by the client. For example, assume that this account in a hotel stands at $207,891.42, and that it is estimated by the client to consist of the following items.

1 It may be interjected here that some businesses classify their property accounts solely by rates of depreciation. Thus all assets whatsoever with a rate of 12% are placed in the one account; and so on. Obviously, there should be another classification by kinds of property for convenience.
As indicated, the auditor should ascertain the annual amount of depreciation of those respective items by applying rates which he deems to be sound. Against this rough estimate of the total yearly amount of depreciation, the auditor should compare the client's figure and adjust its flat rate if necessary, more weight being given to a deficiency in the client's yearly depreciation charge than to an excess thereof. In some instances the auditor may also find it necessary, as a result of this examination, to insist on an increased depreciation reserve, if his certificate is not to be qualified in this respect.

The next step of improvement in keeping the machinery and equipment properly classified is to open in the general ledger a Machinery and Equipment controlling account. The details of this account are then carried in a Property Ledger, just as the details of the Accounts Receivable controlling account are carried in a Customers' Ledger. The Property Ledger would consist of such ACCOUNTS as Machine Foundations, Machinery, (Plates 139 and 140) Steam and Electric Power Plant, Power Piping, Motors, Electric Power Wiring, Machine Pulleys, Machine Bolting, Main Lino Shafting, Fire Equipment, Hand Trucks, Hand Tools, Machine Tools, Dies and Jigs, Factory Furniture and Fixtures, and so on. Each item charged to one of these subledger accounts must, of course, have approximately the same rate of depreciation as every other item in the account, for otherwise the grouping by accounts would be futile.

Finally, the best type of system calls for a Machinery and Equipment controlling account in the general ledger. The details of this account are carried in a Property Ledger, preferably a card system, whose main SECTIONS, not accounts, are the same as the names of the accounts given above; namely, Machine Foundations, Machinery, Etc. Each one of these SECTIONS will be composed of numerous card accounts (Plate 141) containing the record of the assets falling within that classification. Thus in the MACHINERY SECTION alone, there might be 50 to 100 cards keeping track of groups, or of individual presses, lathes, milling machines, drop hammers, grinders, and so on. Indeed, if the plant is a large one, there may be several controlling accounts in the general ledger, such as Machine Foundations, Machinery, Motors, Tools, and so on. In such a case, the total asset values on the property ledger cards for machinery (Plate 141), for example, would tie-in with, i.e., equal the balance of the Machinery controlling account (Plate 142); the property ledger cards for motors would tie-in with the Motors controlling account; and so on for each property ledger and its controlling account.

432. See Plate 138. 433. See Plate 139.
434. See Plate 140. 435. See Plate 141.
436. See Plate 142.

437. The Composition of the Account.—As a rule, the auditor will find at least three charges in connection with each purchase of machinery, namely, the invoice price, the freight and cartage charges, and the installation costs. Each one of these three items is as legitimate a charge to the machinery account as any one of the other two charges. If platforms are necessary, or if the floor supports have to be reinforced, these costs are proper charges to the building account, or to the Machinery Foundations account,—but not to the machinery account. Such platforms or supports have a much longer useful life than a single machine. If, however, this statement is not true in a particular case, no great harm is ordinarily done by

1See also "Auditing and Accounting Handbook", Kilduff, p. 261.
2The auditor should remember that the depreciation on secondhand machinery will be in error if it is brought into the accounts at cost. It should be brought on at original cost with suitable depreciation reserve.
### A Schedule on Machinery and Equipment Plate 138

**Howe & Johnstone, Inc.**  
Machinery and Equipment  
Audit for Six Months Ending June 30, 1929  

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance per G/L and P.S.&amp; Co. 6/30/28</td>
<td>1475329.18</td>
<td></td>
</tr>
<tr>
<td>V-312 S.R.Co. Screw threading Machine #91T for Dept.18</td>
<td>1412.00</td>
<td></td>
</tr>
<tr>
<td>V-417 Freight</td>
<td>197.15</td>
<td></td>
</tr>
<tr>
<td>V-451 Cartage</td>
<td>20.00</td>
<td></td>
</tr>
<tr>
<td>W.O.-74 Installation Costs</td>
<td>75.61</td>
<td></td>
</tr>
<tr>
<td>V-509 M.L.Co. 3-16 x 18 Shaftbury Lathers Dept.14 installed # 143H #144H #145H</td>
<td>4948.00</td>
<td></td>
</tr>
<tr>
<td>V-885 G.E.Co. Motor #734 for Dept.3</td>
<td>650.00</td>
<td></td>
</tr>
<tr>
<td>V-991 Freight</td>
<td>29.73</td>
<td></td>
</tr>
<tr>
<td>V-1050 Cartage</td>
<td>10.00</td>
<td></td>
</tr>
<tr>
<td>W.O.-102 Installation</td>
<td>15.47</td>
<td></td>
</tr>
<tr>
<td>V-1209 S.S.Co. 4 Wooden trucks Dept. 19</td>
<td>260.00</td>
<td></td>
</tr>
<tr>
<td>J-121 G.E.Co. Motor #23456T retired from Dept. #3</td>
<td>593.00</td>
<td></td>
</tr>
</tbody>
</table>

**OPERATION of the ACCOUNT**

All machinery and equipment items are charged to this account. No property ledger exists. The accountant, Mr. Jackson, does, however, keep track of the yearly additions to see that they are not overdepreciated.

**AUDIT PROCEDURE**

All vouchers and Work Orders (W.O.) were examined, and from the nature of the work described therein they were proper additions to this account. We made a careful check of all retirements.

See schedule H5-a for the depreciation reserve.

We checked Mr. Jackson's schedule (see above) and found it to be O.K.

432. **Explanation and Comments.**—This schedule represents an instance of the poorest sort of bookkeeping since only one account is kept for all machinery and equipment. That is, there is no Property Ledger of any sort whatever by which to classify the items according to their respective depreciation rates.

Note that the freight, cartage, and installation costs are proper capital charges.

P.S. & Co. stands for the auditing firm of Price, Sims & Company.
### AN ACCOUNT IN A PROPERTY LEDGER

#### PLATE 139

**JONES AND WEEKS CORPORATION**

**Machinery - 5% depreciation**

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929</td>
<td>Jan. 1 Brought forward from page 12</td>
<td>284496.89</td>
<td></td>
</tr>
<tr>
<td></td>
<td>5 1 BMK Co. #9 Bending Machine Dept. B V-716</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td></td>
<td>28 3 F Co. Boring Machines #18-20 Dept. B V-961</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td></td>
<td>Feb. 22 1 Conveyor F.P. Co. Dept. K V-1154</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td></td>
<td>Apr. 5 2 BBCorp dovetailing mach. #18145 Dept. G V-2016</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td></td>
<td>May 20 1 F K Co. Mortiser #17181 Dept. DFK V-9615</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td></td>
<td>21 2 MTM Co. tapering mach. #01517 Dept. M V9962</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td></td>
<td>June 3 1 PS Corp. woodwork planer #17P Dept. S J-1157</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td></td>
<td>30 1909 additions fully depreciated</td>
<td></td>
<td>205189.15</td>
</tr>
<tr>
<td></td>
<td>Omissions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dec. 7</td>
<td>1 MM Co. Jointers #15 Dept. FK V-13817</td>
<td>284496.89</td>
<td>xx</td>
</tr>
</tbody>
</table>

**Operation of the Account**

All machinery with a life of 20 years is charged to this account irrespective of what it is. Accordingly, the account is governed by the RATE of depreciation and not by the FUNCTION of the machinery.

435. **Explanation and Comments**—This plate represents a case where the machinery accounts are in the Property Ledger along with some twenty other accounts, their total balances being controlled by the MACHINERY AND EQUIPMENT account in the General Ledger. As soon as the additions for any one year become fully depreciated, no further depreciation is taken even though the assets are in operation. Moreover, such fully depreciated additions are charged off immediately against the reserve. Whenever an item is retired LONG before its expected life, the reserve account is charged only with the portion of the reserve belonging to the asset. The method of keeping track of the yearly additions and the reserve is illustrated in Plate 140.

1E.G. Machinery - 5% depreciation; Machinery - 8% depreciation; Machinery - 20% depreciation, and so on; i.e. classified by depreciation rates and not by likeness of function.

2See plate 151.
A PROPERTY LEDGER CARD  PLATE 141

Item (Name of the machine) Purchased from Hubbard & Bartlett P.O. #708 
Dept. D1K 
Plant No. 8171M 
Life 
Mfrs. No. 32175 

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>R Normal</th>
<th>E Repairs</th>
<th>Costs</th>
<th>Annual Depreciation</th>
<th>F Depreciation Reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>1923</td>
<td>May 7 (Name of machine)</td>
<td>V81</td>
<td>4689.00</td>
<td>95.32</td>
<td>327.75</td>
<td>327.75</td>
</tr>
<tr>
<td></td>
<td>Freight</td>
<td>V82</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Installation No. 14</td>
<td></td>
<td>147.89</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td></td>
<td>4932.21</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1924</td>
<td>Dec. 31 4682.21 X .07 =</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1925</td>
<td>Aug. 7 (State repairs)</td>
<td>V117</td>
<td>51.68 (No time lost)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dec. 31 4682.21 X 14 2/7 =</td>
<td></td>
<td></td>
<td>668.89</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Mar. 3 (State repairs)</td>
<td>V12</td>
<td>81.75 (1/2 day lost)</td>
<td></td>
<td>2334.42</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dec. 31 4682.21 X 14 2/7 =</td>
<td></td>
<td></td>
<td>668.89</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1927</td>
<td>Sept. 7 (State replacement)</td>
<td>V41</td>
<td>(250.00)</td>
<td></td>
<td>2084.42</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Oct. 8 (State repairs)</td>
<td>V69</td>
<td>102.12 (2 days lost)</td>
<td></td>
<td>2753.31</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dec. 31 4682.21 X 14 2/7 =</td>
<td></td>
<td></td>
<td>668.89</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Feb. 6 (State repairs)</td>
<td>V16</td>
<td>49.61 (1/2 day lost)</td>
<td></td>
<td>(450.00)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Apr. 18 (State replacement)</td>
<td>V8</td>
<td></td>
<td></td>
<td>2303.31</td>
<td></td>
</tr>
<tr>
<td></td>
<td>July 1 4682.21 X .07 =</td>
<td></td>
<td></td>
<td>327.75</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dec. 31 4682.21 - 2631.06 X .125 =</td>
<td></td>
<td></td>
<td>256.39</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1929</td>
<td>Mar. 19 (State repairs)</td>
<td>V49</td>
<td>16.71 (No time lost)</td>
<td></td>
<td>2887.45</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dec. 31 4682.21 - 2631.06 X .25=</td>
<td></td>
<td>512.78</td>
<td></td>
<td>3400.23</td>
<td></td>
</tr>
</tbody>
</table>

Jan. 7 Sold for $1000.00-
Loss $531.98 CB15 (4932.21) (3400.23)

435. Explanation and Comments.-- The life history of each machine, or group of like machines having the same depreciation rate, is recorded on a card. The total asset value of all cards on machinery must tie in with the controlling account in the general ledger. The same thing is true in regard to the reserve for depreciation.

Note that the total annual depreciation charge for machinery would be ascertained by adding together the annual depreciation charges of the individual cards.

Also, note that a record of the ordinary repairs required by this machine is a part of this particular system. Such a record is a fine basis for deciding how satisfactory the make of machine is.

As the cost of the old replaced parts is unknown, the cost of the new parts is charged in full to the reserve. The $450 replacement in 1928 extended the life of the machine for two extra years; i.e., from 7/1/30 to 7/1/32. The $250 replacement in 1927 had no such effect.
**A SCHEDULE ON MACHINERY  PLATE 140**

Jones and Weeks Corporation

Machinery - 5% Depreciation

Audit for Year Ending Dec. 31, 1929

<table>
<thead>
<tr>
<th>(LEFT SIDE)</th>
<th>Hadley</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1-18-30</td>
</tr>
</tbody>
</table>

**Bought**

<table>
<thead>
<tr>
<th>Year</th>
<th>Balance 12/31/28</th>
<th>Additions 1929</th>
<th>Retirements</th>
<th>Balance 12/31/29</th>
</tr>
</thead>
<tbody>
<tr>
<td>1909</td>
<td>205189.15</td>
<td>10129.75</td>
<td>1789.21</td>
<td>205189.15</td>
</tr>
<tr>
<td>10</td>
<td>10129.75</td>
<td></td>
<td></td>
<td>10129.75</td>
</tr>
<tr>
<td>11</td>
<td>543.34</td>
<td></td>
<td></td>
<td>543.34</td>
</tr>
<tr>
<td>12</td>
<td>1789.21</td>
<td></td>
<td></td>
<td>1789.21</td>
</tr>
<tr>
<td>13</td>
<td>818.19</td>
<td></td>
<td></td>
<td>818.19</td>
</tr>
<tr>
<td>14</td>
<td>1462.24</td>
<td></td>
<td></td>
<td>1462.24</td>
</tr>
<tr>
<td>15</td>
<td>650.14</td>
<td></td>
<td></td>
<td>650.14</td>
</tr>
<tr>
<td>16</td>
<td>650.14</td>
<td></td>
<td></td>
<td>650.14</td>
</tr>
<tr>
<td>17</td>
<td>2587.93</td>
<td></td>
<td></td>
<td>7417.17</td>
</tr>
<tr>
<td>18</td>
<td>5183.24</td>
<td></td>
<td></td>
<td>5183.24</td>
</tr>
<tr>
<td>19</td>
<td>49176.53</td>
<td></td>
<td></td>
<td>49176.53</td>
</tr>
<tr>
<td>20</td>
<td>100349.18</td>
<td></td>
<td></td>
<td>100349.18</td>
</tr>
<tr>
<td>21</td>
<td>284946.69</td>
<td>100349.18</td>
<td>207777.68</td>
<td>177518.99</td>
</tr>
</tbody>
</table>

**O.K. per Fl-a Fl-b G/L**

**12/31/29**

434. **Explanation and Comments.**—This plate represents a method for keeping track of the proper depreciation of a property ledger account such as shown in Plate 139.

Schedule Fl-a ($100349.18) would be, in the main, a verified copy of the client's property ledger account (Plate 139).
### Balance 12/31/28

<table>
<thead>
<tr>
<th></th>
<th>1929 Additions 5%</th>
<th>1929 Charges</th>
<th>12/31/29 Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>200059.42</td>
<td>5129.73</td>
<td>206189.15</td>
<td>9876.51</td>
</tr>
<tr>
<td>9370.02</td>
<td>506.49</td>
<td></td>
<td></td>
</tr>
<tr>
<td>448.26</td>
<td>27.17</td>
<td></td>
<td>475.43</td>
</tr>
<tr>
<td>1297.17</td>
<td>89.46</td>
<td></td>
<td>1386.63</td>
</tr>
<tr>
<td>470.46</td>
<td>40.91</td>
<td></td>
<td>511.37</td>
</tr>
<tr>
<td>767.58</td>
<td>73.11</td>
<td></td>
<td>840.79</td>
</tr>
<tr>
<td>211.30</td>
<td>32.51</td>
<td></td>
<td>243.81</td>
</tr>
<tr>
<td>1750.89</td>
<td>435.55</td>
<td>517.59</td>
<td>1668.85</td>
</tr>
<tr>
<td>388.74</td>
<td>259.16</td>
<td></td>
<td>647.90</td>
</tr>
<tr>
<td>1229.42</td>
<td>2456.73</td>
<td></td>
<td>3668.25</td>
</tr>
<tr>
<td></td>
<td>2508.73</td>
<td></td>
<td>2508.73</td>
</tr>
</tbody>
</table>

| 215993.36 | 11561.65          | 205706.74    | 21848.27         |

### O.K. per

<table>
<thead>
<tr>
<th>O.K. per</th>
<th>1929 Adj. 1/6</th>
<th>O.K. per</th>
<th>1929 To F</th>
</tr>
</thead>
<tbody>
<tr>
<td>G/L</td>
<td></td>
<td>12/31/29</td>
<td></td>
</tr>
<tr>
<td>12/31/28</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Proof of Depreciation Charge

| Opening balance 1/1/29 | $284946.89 \times 0.05 \times 1 = 14247.34 |
| Retirements 1929       | $207777.06                                      |
| Additions 1929         | $100349.18                                      |
| Net Additions 1929     | $107427.90 \times 0.05 \times 1/2 = 2685.70    |
|                        | $11561.64                                      |

### Operation of the Accounts

As soon as a Reserve reaches the full amount of the asset additions for that year, no further depreciation is taken. The assets are charged off immediately against the Reserve, even though the assets are still in existence. Extremely short lived assets, including those sold and the like, are allowed only the portion of the Reserve actually belonging to them when they are charged off on retirement. Great care is taken to adjust the rate from time to time as operating conditions change.
### A Schedule on Summary of Machinery Cards Plate 142

**HOFFMAN & OLLRICH, INC.**

**Summary of Machinery Cards**

**B/S Audit for Year Ending Dec. 31, 1930**

<table>
<thead>
<tr>
<th>C</th>
<th>Assets</th>
<th>Reserve</th>
<th>(Gain)</th>
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<tr>
<td>A</td>
<td></td>
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<td></td>
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<tr>
<td>R</td>
<td>Bal.</td>
<td>1930</td>
<td>Bal.</td>
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<tr>
<td>D</td>
<td>12/31/30 additions</td>
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OK OK OK OK OK OK per G/L

---

**Explanation and Comments.**—This plate was made up from property ledger cards such as is illustrated in plate 141. Plate 141 is recorded on the last line of this plate. It is card 1052.

The reader should realize that under this method the annual depreciation charge is not ascertained by multiplying the general ledger balances by an average rate of depreciation. On the contrary, the total depreciation is the sum of all of the individual computations recorded on the property ledger cards.

The $3700 charge to the reserve was the estimated cost of an old part replaced by a new one costing only $514.17. Quite frequently, however, the cost of the new part is treated as being the same as that of the replaced part; i.e. the new part is charged direct to the reserve for depreciation. This procedure is incorrect unless the difference in cost is negligible.
charging these expenditures to machinery.

If an OCCASIONAL machine is constructed within the plant, all material and labor costs expended in building the unit are properly capitalized as a cost of the machine. But, as emphasized in chapter 23, only the EXTRA overhead incurred in making this machine should be treated as its overhead cost. If, for example, departments A, C, D, K, and M are called upon to produce parts of a single machine for home use, no overhead at all should be applied by the factory production departments to the cost of the job, unless the job caused them some extra expense that would not otherwise have been incurred. The main reason for this procedure is conservatism. In general, ordinary production operations will be carried on as usual. Indeed, such special jobs will usually be dropped in order to accept a customer's order, or to get a customer's order out on time. Therefore, the overhead to be applied to work done for customers must NOT be reduced by having some of it applied to the jobs done for home use. If this method of dealing with overhead is not adopted, the cost of production on customers' work will appear lower than it really is: As a direct consequence of this error, certain customers' jobs may be taken at a loss or at least at an insufficient profit. Furthermore, the profit for the period is greater than it otherwise would be to the extent of the regular overhead applied to the job. As profit (if any) does not arise at the time of the acquisition of an asset, but at the time of sale (here via depreciation charges), it appears necessary to set the asset up at the lower figure in order to secure the lower depreciation charges.

At times, particularly in the case of consolidations, mergers, etc., the auditor will find that appraisal company values, or the values established by the Valuation Committee of the Board of Directors, have been set up in the books of account. All that the auditor is obliged to do in such instances is to make certain that these book figures are in agreement with the respective appraisals; that the appraisal surplus has been properly handled; and that his own report and certificate definitely state the basis on which the machinery is valued.

If machinery is bought on the installment plan, so that the title remains with the vendor, the full cost should be brought on the books as an asset, and the net liability, i.e. full cost less initial payment, if any, as a current liability, if such it really is. It is not advisable to merely record the installment payments as they are made. If this recommendation is followed, depreciation will then be computed upon the full cost, as it should be, and not upon the installment payments balance. Moreover, the asset and the liability will be properly shown from an accounting and business (but not legal) point of view. If interest is included as a part of the total cost stated in the contract, this sum is a deferred charge, and not a part of the machinery cost.

Whenever royalty or rental payments are met with, they are usually operating expenses, despite the fact that the company's accountant may have placed them in the machinery account. On some occasions the client may have an option allowing the payments to be applied on the purchase price if the machinery is accepted within a certain time, etc. If the client fully intends to purchase the machinery, the royalty or rentals are chargeable to the liability account, assuming that both the asset and the liability have been set up—which they should be.

As explained in section 317, mere rearrangement costs must not be entered in the machinery account. The most liberal treatment is to set up these expenditures in a Rearrangement of Machinery account, to be written off rapidly. This treatment is predicated on the assumption that the rearrangement is successful in accomplishing the purpose for which it was

---

1See section 399. 2Except where standard costs, etc. are used. 3See section 638. 4See Appendix C, Sec. 10-2.
undertaken. If it wasn't successful, the expenditures must be charged off directly as a total loss.

The best procedure is to write off the old installation costs, including the present costs of "up rooting" the machinery etc., against the allowance for depreciation (for the proper amount), and surplus (for the amount of the loss). If this is done, the new installation costs should be added to the machinery account. This, to repeat, is the proper treatment; the other one mentioned is barely permissible.

438. The Verification Procedure.—In the main, the verification of the machinery is chiefly limited to seeing that the charges and the credits in the account are legitimate, correctly priced, and properly handled. This procedure is far different from the verification of current assets, where the auditor in addition to proving the correctness of the entries in the account, etc. must also verify the existence of these assets: To be certain, many leading auditors are now-a-days test-checking the machinery property ledger items against the actual physical machinery, or they are making an inspection tour of the plant, both to see that newly recorded purchases are actually in existence, and to see that no machinery has been retired or removed without being recorded on the books of account. These auditors do not believe that it is wise or sufficient to wait until a slump in production, or other cause, notifies them that something is wrong with the machinery account. Successful auditing can not be conducted by staying in the main office.

On the other hand, for example, present day auditing practice does not require an auditor to go to the branch plant in X city in order to make certain that the machinery which is shown on an approved and satisfactory voucher in the files at the main office in F city, was in existence on the audit date. If production does not slump, if there are no suspicious circumstances, or if nothing unusual happens to act as a warning to an alert auditor, he is justified in assuming that the machinery is in existence in X city.

To reiterate, it is generally sufficient for the auditor to confine his attention wholly to the account, but the better practice is for him to include some physical verification of the machinery wherever it is feasible.

In analyzing the account, the auditor may be called upon to review creditors' vouchers, internal requisitions, time cards, cost sheets, appraisal reports, contracts, minutes, etc.. Thus, if a machine is purchased, there will be a supporting voucher, but if it was made by the client, there will be a cost sheet supported by internal requisitions and time cards. On the other hand, if the machinery has just been appraised, the engineers' appraisal report must be seen, and, in the case of mergers, consolidations, et cetera, there may be a report by the Valuation Committee.

If any machinery has been bought on the installment plan, the auditor must always see the contract thereon. He should then abstract the essence of the contract for his working papers. In this way the auditor will ascertain the nature and extent of the seller's lien, the cost, the interest charges, and all other essential data urgently needed in order to present a full and correct picture of the transaction.

It is not unusual for an auditor to find that although purchase money notes have been issued for machinery, none of them (at the outset) have been recorded in the books-of-account. The client usually debits the machinery account only when he pays off one of the installment notes. The interest also may be capitalized. Obviously, the client by the omission has offset i.e. cancelled a liability against a pledged asset. Furthermore, the proper value for depreciation is not stated in the account.
Even in a balance sheet audit, a review of the Repairs and Maintenance account is an essential part of the verification, lest an asset or a proper charge to a depreciation reserve be incorrectly included therein. At this point it must be remembered that certain businesses have established a dollar mark below which all expenditures are expensed even though the items are true assets.

Retirements will be verified chiefly (1) by the auditor's asking himself, "Is this a true addition or a replacement?", (2) by making a tour of the plant in order to observe any retirements, (3) by checking the property ledger against the physical items, and (4) by judicious inquiry of bosses, plant superintendent, and others.

439. The Balance Sheet Valuation.—As with other Plant Property, the machinery of a going concern should be stated on the balance sheet at original cost less depreciation, or at replacement cost less depreciation. As will be pointed out in the chapter on depreciation and obsolescence, reserves for depreciation which are based on natural life depreciation must very often be replaced by reserves based on depletion or obsolescence. All abandoned obsolete machinery must be written down to $1, or some other insignificant sum.

440. Comments on Balance Sheet Presentation.—Ordinarily, the machinery account with its depreciation reserve is an item under the main caption of PLANT PROPERTIES. As stated in the discussion of Plant Property in chapter 23, at least the net additions for the period of both the asset account and the reserve for depreciation account might very well be embodied in the face of the balance sheet. If this is not thought to be advisable, it certainly is always a welcomed comment in the report. In fact, the gross additions and deductions of both accounts should be shown here.

Whenever machinery is bought on the installment plan and the title to it has not passed to the client, the full cost of the machinery less its depreciation reserve and the unpaid balance may be set up on the asset side of the balance sheet, or, the full cost less the reserve may be stated as an asset with the unpaid balance as a current or fixed liability, as the case may be. The former presentation gives effect to the legal aspects of the situation, whereas the latter presentation gives the business point of view. The writer favors the latter method. Furthermore, a notation must be made to the effect that the title to the machinery rests with the vendor and that the liability is secured. This can be done as follows:

Machinery (title with vendor) $xx

Money Mortgage $xx

Expenditures properly classed as rearrangement costs must not be listed under Plant Property, because they do not improve the machinery itself or its efficiency over what might have been if properly installed and lined-up in the first instance. In fact, the only reason why the expenditures may be temporarily capitalized at all is because the benefit of the rearrangement is not limited to the year in which the expenditures are made. It seems best, therefore, to place Rearrangement Expenditures under OTHER ASSETS. See section 317.

If any machinery is in the stores-room or elsewhere, either for the purpose of taking the place of another unit should it break down, or because the process on which it was used has been abandoned, it must not be included in the inventories under current assets. Usable replacement machinery may be listed under Plant Property, but unusable obsolete machinery, unless it is written down to $1, must be listed as an item under OTHER ASSETS.

1 This should be done whenever there has been a major change in the price level. 2 See Appendix C, Sec. 14-#11.
On rare occasions special care will have to be given to the subdivision of the machinery account as between real and personal property, in an effort to show on the face of the balance sheet the amount of the machinery covered by a chattel mortgage bond issue (not a purchase money chattel mortgage).

441. See Plate 143.

441a. Audit Program

(1) The auditor should use his influence to get the client to carry the machinery and equipment in proper accounts, suitable for depreciation purposes.

(2) If the client has a single account for machinery and equipment, the auditor should have the client break it down into the group classifications designated by him. To the estimated sums so assigned to the groups by the client, the auditor should apply proper rates of depreciation and thereby secure a check upon the client's annual depreciation charge. If the variation between the auditor's estimate and the client's figure is large, the auditor should adjust the latter and also ascertain if the allowance account needs adjusting too.

(3) Freight and cartage charges, plus installation costs are proper capital additions.

(4) Secondhand machinery should be brought on to the books at the original cost with a depreciation allowance sufficient to reduce the gross figure to the cost. If this is not done, it is likely that the annual depreciation will be too small.

(5) Only that overhead specially incurred for the job should be included in the cost of machinery made for own use. If the machinery is made during subnormal operations, the cost may include the same amount of factory overhead as would be included in the price charged to a customer.

(6) Ascertain whether or not any machinery or equipment is subject to obsolescence. If so, do not use the depreciation rate applicable to normal useful life.

(7) Ascertain whether or not all machinery is actually in use. If not, classify properly. See that the carrying value is reasonable. Do not carry obsolete and/or auxiliary machinery found in "Stores" as inventory; treat as a part of plant.

(8) Verify the titles to personal property acquired. What liens, if any, exist?

(9) When machinery is purchased on an installment plan, the total cost should be set up as an asset and the unpaid installments as a current liability (if they are payable within a year). Show on the balance sheet that the machinery is the vendor's. Take depreciation on the full cost. Abstract the contract.

(10) If the client fully intends to purchase the machinery which he is now renting, with privilege of applying the rents to the purchase price if the option is exercised, the total cost and corresponding liability should be set up. The rents should be charged to the liability account. If this is cancelled, the excess paid, if any, is an expense. Abstract the contract.

(11) Make a tour of the plant noting: (1) general condition of the machinery; (2) additional machinery added; (3) machinery retired; (4) etc. Make inquiries of the bosses and/or secondhands.

(12) Review the Repairs and Maintenance account for assets expensed.

(13) If the amount of repairs and maintenance is subnormal, consider the advisability of setting up an allowance for accrued maintenance.

(14) Rearrange expenditures, if properly capitalized, are OTHER ASSETS not PLANT.

(15) "Check the receipt of assets purchased outside by means of the receiving record."
A SUMMARY SCHEDULE ON MACHINERY AND ITS RESERVE PLATE 143

Hobson & Fils, Inc.

(1) Summary of Machinery and (2) Reserve for Depreciation
Audit for the Year Ending December 31, 1928

(LEFT SIDE)

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<td>2. Dept. DDRA Additions</td>
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MISSIONS

| 1. Dept. HPLA Additions | 143177.09 | 15418.15 | 17429.16 |
| Retirements | (31536.87) | 16387.14 | 15149.73 |
| Correct Balance 12/31/26 To H | 566209.95 | 28917.65 | 91424.41 | 4321.78 |
| Z Adjustment #25 | 501171.32 |

RESERVE FOR D

CREDITS TO THE RESERVE:

| 1. Dept. DKFA Yearly depreciation | 158895.78 | 21018.87 | 14147.62 | 14417.62 |
| 2. Dept. DDRA | 27932.22 | 6207.16 | 6207.16 | 6207.16 |
| 1. Dept. HPLA | 105329.77 | 11256.06 | 11250.92 | 11032.98 |

Total Yearly Depreciation | 450505.66 | 56109.15 | 49910.01 | 44219.69 |

CHARGES TO THE RESERVE:

| 1. Dept. DKFA Charges | (104196.41) | (10300.17) | (93896.24) |
| 1. Dept. HPLA Charges | (23714.52) | (13109.71) | (10664.81) |

Total Yearly Charges | (351760.52) | 191417.20 | 145224.15 | 15019.18 |

Q Correct Balance 12/31/28 To H | 68745.33 |

V Balance per G/L 12/31/27 | 21617.21 |

C Adjustment #25 | 47128.12 |

CHECK PROOF:

V Reserve 12/31/27 per G/L | 21617.21 |

T 1928 Depreciation | 56109.15 |

Q Correct Reserve 12/31/28 | 68745.33 |

Excess | 8981.03 |

Z Net Asset Correction 12/31/28 | 65036.53 |

D Earned Surplus | 74019.66 |

ADJUSTMENT #25:

T Depreciation Expense | 56109.15 |

Z Machinery | 65036.53 |

C Depreciation Reserve | 47128.12 |

D Earned Surplu | 74019.66 |

121147.78 | 121147.78 |
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OMISSIONS

1. Rate 10%
2. " 15%

441. Explanation and Comments.—This exhibit was prepared by an auditor who was required to analyze the account from its inception in 1918.

Note that the asset balance in the ledger was $65,036.63 short; that the year’s depreciation of $56,109.15 had not been set up; and that the Reserve for Depreciation was $6,981.03 over (after considering the 1928 depreciation), so that the earned surplus credit was $74,019.66 ($65,036.63 plus $8,981.03).
(16) Examine the directors' minutes (or other authority) for each major addition or disposal.
(17) If an appraisal has been recorded, review the appraisal report to see that it has been properly recorded. Pay particular attention to the amounts assigned to capital surplus and earned surplus, if any.
(18) Make certain that each credit to the account is the same in amount as the original debit.
(19) Ascertain the adequacy of the allowances for depreciation.
(20) In the case of each debit, ascertain whether it is a replacement or whether it is an additional unit. If it is the former, make certain that the asset retired is credited to the asset account and charged to the allowance account at proper values.
(21) In the case of each credit, ascertain if the item has been replaced. If so, make certain that it has not been expensed.
(22) Prepare the allowance for depreciation on the schedule as the asset is, if this is feasible.
(23) Show separately on the balance sheet all machinery subject to liens.
(24) Consider the advisability of suggesting that the machinery be brought into line with present day values.
(25) "Inquire concerning standard or special machinery and equipment in progress of construction, at the plants of vendors, for which the client is committed on purchase contracts."
(26) Ascertain if leased equipment is being properly handled. Abstract contract. Do same for any machinery leased by the client.
(27) Ascertain how depreciation is handled on used machines in "Stores".
(28) Apply sections 407a and 430a when applicable.

REVIEW QUESTIONS

1. Where on the balance sheet would you place abandoned machinery?
2. What sort of verification of machinery does the best type of procedure call for?
3. Why is it necessary to test and scrutinize the Repairs and Maintenance account when auditing the machinery accounts?
4. What is the objection to charging machinery built for internal use with overhead at regular factory rates? What is the correct overhead to be applied?
5. Why is it often advisable to have a machinery foundations account?
6. How would you handle expenditures incurred in rearranging machinery?
7. Wherein is the verification procedure for fixed assets different from that used in connection with current assets?
8. What accounts would you use in setting up machinery which was being bought on the installment plan?
9. Give two situations requiring different treatments of royalty payments.
10. What should the auditor do to assure himself that an entry had been made for each piece of machinery that has been retired?
11. How would you set up on the balance sheet machinery (title to which remains with vendor) which has been bought on the installment plan?
12. Describe three different accounting methods for keeping track of machinery and equipment. Which method do you recommend?
A - Tools

442. General Discussion.
443. The Composition of the Account.
444. The Verification Procedure.
445b. The Balance Sheet Presentation.

B - FURNITURE AND FIXTURES

446. The Composition of the Account.
447. Explanation of Plate 144.
   PLATE 144 - A Schedule on Office Furniture and Fixtures.
448. The Verification Procedure.
449. The Balance Sheet Valuation.
450. The Balance Sheet Presentation.
451. Explanation of Plate 145.
   PLATE 145 - A Schedule on Furniture and Fixtures, and Reserve for Depreciation.

C - DELIVERY EQUIPMENT

452. General Discussion.

D - CARRIERS AND CONTAINERS

453. General Discussion.

E - MOLDS, PATTERNS, DRAWING, AND DIES

454. General Discussion.
455. Explanation of Plate 146.
   PLATE 146 - An Outline of a Schedule on Molds, Patterns, Dies, Etc.
455a. Audit Program.

A - TOOLS

442. General Discussion.-- Under ideal conditions there is a tool room under
look and key and in charge of a responsible clerk. Every tool is catalogued
so that each workman may know just what tools are available, assuming that
there is no planning department to determine the particular tools to be used.
Then too, a properly developed catalogue is useful in case the tool-keeper
temporarily forgets where a tool is located. Moreover, if the tool-keeper
leaves or is sick, his substitute will be able to carry on much more readily
than otherwise.

As indicated, each tool has its own adequate location in the tool room,
so that every one of them is properly cared for and readily located when
needed. Each compartment is numbered or otherwise designated, and the name
and size of the tool within is also given.

Whenever a workman secures a tool, he must deposit one of his numbered
brass checks with the tool-keeper. Each workman will, of course, have been
previously provided and charged with a few brass checks, all of the same
number.
As soon as a tool is given out to a workman, his brass check, which he turns in, is hung up outside the bin. As a result, the tool-keeper can readily tell what tools are out and what workmen have them.

As an important part of this tool program, the tool-keeper is charged with the inspection of all tools as soon as they are returned to his. Those which are in good condition are replaced in their respective bins; those which are worn out are made the subject of a requisition for replacement; those which have been decidedly abused are charged to the workman; and those which are in need of repairs, or resharpening, or returning are sent directly to the Repair and Maintenance department for immediate attention.

As a result of this procedure, thefts and losses of tools are reduced to a minimum; every workman knows what tools are available and hence is able to plan his work the easiest way possible (assuming that there is no planning department); the proper care of the tools is impressed upon the workmen by the very nature of the system; delays from misplaced tools are practically unknown; and delays and anger arising from getting a tool which is dull, or out of order, are also nil.

A second plan of control has been outlined by Mr. V.W. Jones (The American Accountant, Feb. 1932 p.4) as follows. "First of all it must be stated that this plan provides for the charging to property or fixed asset accounts, of the original purchase of all standard tools which are new or additional equipment. No depreciation is charged on this account but all subsequent purchases, which are in the nature of replacements, are charged to expense. Also any items which are discontinued are removed from the account. The real control then is obtained by the physical accounting for the asset.

A standard tool inventory control ledger (form 1) is carried by the property division of the accounting department into which are posted all original purchases of standard tools, the total thereof being charged to property. This ledger is divided according to the various tool cribs and provides for the recording of the date purchased, description of the tool, invoice number, identification symbol, cost and disposal record. Corresponding with this, a file is maintained in each tool crib which provides a compartment for maintaining the record on each tool. This file, with equipment used, is composed of hinged boards the faces of which are divided into small compartments with a hinged clip in front of each. Each compartment is assigned a definite identification number which corresponds to the type of tool it is to represent and a small inventory card (form 2) is placed therein. On this inventory card is carried a record of all those particular tools which are in stock. The card provides for the tabulating of the identification number, description, bin number, date purchased, invoice number, cost and disposal record. Therefore, the total value of these files at all times equals the total value of the ledger sheets for each tool crib.

As these tools are maintained for the definite purpose of being loaned to the various employees in the conduct of their work, it is necessary further to provide for a record which will indicate, at all times, the employees in whose possession they are. Everyone is presumably acquainted with the metal check system, which has been so extensively used, whereby the employee exchanges a check, with his clock number thereon, for a tool. This check is of course placed in the bin or on the rack and supposedly returned to the employee when his tool is turned in. Everyone also presumably knows the arguments that have ensued therefrom and the unsatisfactory conditions which result.

Under the plan described herein, another file is maintained by the
<table>
<thead>
<tr>
<th>Date</th>
<th>Identification</th>
<th>Cost</th>
<th>Date Disposal</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1930 Jan. 6</td>
<td>1-6 foot Step</td>
<td>3.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1-342 52649</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 Model C Redi-socket wrenches</td>
<td>1-578 52764-5</td>
<td>2.95</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16 1-24&quot; Rigid Pipe Wrench</td>
<td>1-891 52801</td>
<td>4.65</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21 3-#6 Scoop Shovels</td>
<td>1-1350 52995</td>
<td>1.95</td>
<td>3/5/31 Scrapped</td>
<td>1.95</td>
</tr>
<tr>
<td></td>
<td>52995</td>
<td>1.95</td>
<td>4/2/16</td>
<td>1.95</td>
</tr>
<tr>
<td></td>
<td>52997</td>
<td>1.95</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1931 Aug. 29</td>
<td>Taps &amp; die Outfit</td>
<td>Balance 2400</td>
<td>9/1/31 O.K.</td>
<td></td>
</tr>
<tr>
<td>1-891 52801</td>
<td>4.65</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27.90</td>
<td>24&quot; Rigid Pipe Wrench</td>
<td>9-217 54001</td>
<td>6.25</td>
<td></td>
</tr>
<tr>
<td>2 #7 Tin Snips 15&quot;</td>
<td>9-265 53816</td>
<td>1.50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 1-24&quot; Rigid Pipe Wrench</td>
<td>9-897 52801</td>
<td>4.65</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**IDENT. NO.** 52801

<table>
<thead>
<tr>
<th>Descrip.</th>
<th>Bin No.</th>
<th>Date</th>
<th>Invoice</th>
<th>DISPOSAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>24&quot; Rigid Pipe Wrench</td>
<td>C-15</td>
<td>1-6-30</td>
<td>1-891</td>
<td>4.65</td>
</tr>
<tr>
<td>9-3-31 9-897 4.65</td>
<td></td>
<td>9-897</td>
<td>4.65</td>
<td></td>
</tr>
</tbody>
</table>

**A.B.C. COMPANY**

**TOOL ORDER**

<table>
<thead>
<tr>
<th>Tool No.</th>
<th>Clock No. 27</th>
<th>Tool No. 52801</th>
<th>Date Dec. 10 19 30 Job. No. 32606</th>
</tr>
</thead>
<tbody>
<tr>
<td>24&quot; Rigid Pipe Wrench</td>
<td></td>
<td></td>
<td>1 24&quot; Rigid Pipe Wrench</td>
</tr>
</tbody>
</table>

**WORKMAN NOTE.** This Tool is in Your Charge until it is Returned. If lost, it will be charged to You. Keep this slip until tool is returned. Then exchange it for your receipted slip.

Signed __________ A. Employee

This Tool Order is for one item only.
crib keeper similar to the tool record file, but this file provides a space for each workman. A pad of tool-orders (form 3) is carried by the crib keeper which are similar in many respects to the ordinary sales slips used in retail establishments.

These tool orders are in triplicate and provide for the recording of employee's clock number, tool number, date, job that tool is to be used on, description of tool and employee's signature. When the employee needs a tool he simply proceeds to the crib, makes out his own order, signs it, and presents it to the tool keeper. The tool and triplicate of the order are delivered to the employee, the duplicate is filed in the tool record file in front of the inventory card and the original is filed in the employee's record file against the employee's clock number. Upon return of the tool, the tool keeper inspects it and if it has not been abused through carelessness, the original and duplicate slips are removed from the files and returned to the employee.

If, through carelessness, the tool has been broken or misused, such notation is made on the slips which are returned to the workman and the condition is referred to the foreman for investigation and determination as to whether or not a charge is justified against the employee. Of course the failure to return a tool at all is guarded against by the fact that the employee's own signature is on file for each tool he has secured.

Any tools which are discontinued and not replaced are removed from the file and notice forwarded to the accounting department. All tools which are replacements are so marked on the purchase order. The purchasing department will not accept any orders for delivery to tool cribs which are not marked either "new equipment" or "replacement". Also all requisitions and invoices for standard tools pass through the property division for verification of charge.

The accounting department has a perfect control because the sum of the value presented by the inventory record cards in each crib must at all times coincide with the control ledger. Also, the physical stock in the crib can be checked at all times. The quantities of each tool on hand in the crib must equal the total of the inventory card less the employees' charge slips which are on file in front of the card. Also, each workman must be able to produce all tools for which he is charged.

This method, simple as it may seem to describe is even simpler of operation. It establishes an accounting and physical control which is foolproof and in the long run is productive of unbelievable savings. It eliminates possibility of carelessness, theft, and other causes that result in loss to the company and it is through the elimination of such losses that profits are realized.

443. The Composition of the Account.-- As a rule, hand and shop tools are limited to this account, whereas machine tools (not attachments) are more properly grouped by themselves, being subject to more rapid depreciation. Bits, braces, hammers, pliers, saws, chisels, mallets, shears, etc. are the stock items of this account.

Naturally, it is perfectly proper to charge the account with all acquisitions, and credit it at cost with all retirements. If this plan is used, the reserve for depreciation will be handled as usual. But obviously, as this treatment requires a maximum amount of care and of bookkeeping, it is not likely to be found on many audit engagements.

The practice of capitalizing all tool purchases, until such time as the tool equipment is fairly complete, together with the charging of annual depreciation at a high rate for these years, and thereafter charging the new tool replacements to revenue, is recommended. This method is admittedly a rough one, but essentially accurate if applied with a grain or two of common sense. Is it not likely that all purchases at the outset are actual
capital additions, and that after a full complement of tools has been acquired, the other future purchases are mainly replacements? Of course, future substantial additions (not replacements) to the tool equipment must be charged to the account rather than to expense.

If this plan is adopted, the reserve for depreciation is not increased after the date at which all new tool replacement purchases are expensed, except for depreciation on the new additions to the account. However, a physical inventory should be taken every three or five years, to which basis the accounts should be adjusted.

A third plan for keeping the tool account is for the client to actually inventory the tools each year, and value them at cost less a reserve of 40 to 50 per cent, or, each tool may be inventoried at its own particular estimated sound value. This plan is readily adaptable to all situations whether or not a tool room is maintained. Practically every one is agreed that it is by far the best plan of the three.

If a tool is made occasionally within the plant for home use, it may, according to a certain school of cost accountants, take an equitable part of the overheads of the various departments which did the work. This is sometimes an allowable treatment, but it is usually not a sound one and should be discouraged. As regular production for customers will not be reduced because of this occasional special work, the normal departmental overheads ought to be reduced by applying some of it to this special work. Prime cost (direct material and direct labor), plus all specifically incurred (extra) overhead (if any), represents the conservative method of valuing tools, or any other item, made by the client for its own use. There is no legitimate basis for valuing a tool with it, S has only $50 and makes a $70 tool with it, S has effected a saving of $20. Would it be sound, however, for him to borrow $20 against the tool, and spend it on the assumption that he has made that much profit? As the answer is obviously and unequivocally "no", the use of the market purchase price with its attendant paper profit must likewise be incorrect and unsound for a business to use. It is only when and if the tool is sold for $70, either for cash or via articles produced with it, that the $20 profit is realized. Thus it is obvious that there is not only an IF involved, but also (perhaps) a period of five years (life of the tool) before the whole of the $20 is earned, if at all.

444. The Verification Procedure.—In common with the verification of other Plant Property items, the auditor often has to rely more upon vouchers, requisitions, time cards, and common sense in checking up the Tools accounts than upon physical examination. For example, if all additions to the account are voucher, and if the yearly additions are kept separate on a schedule so it can be told when they are fully depreciated, and if the depreciation rate is satisfactory, the auditor can ordinarily accept the balance in the asset and reserve accounts without having to go out into the shop and account for the physical existence of individual tools,—as he would have to in case of securities. However, the auditor should go into the shop to make a general

If tools are constantly and regularly being made within the plant for home use, it is usually expedient to apply to the prime cost thereof the regular percentages of departmental overheads because it is generally true that the sum total of the factory overhead has been increased because this work has been done.

Theoretically a lesser rate than the usual departmental overhead should be applied inasmuch as certain overhead items, such as taxes, have not been increased because of those jobs.
survey of the tools. This reliance in a general survey is reasonable because production cannot be carried on smoothly without the existence of a more or less full supply of tools. Moreover, although thefts of tools are common, there is not the same loss per unit stolen as with securities.

Although there is usually no annual inventorying of the tools, all auditors strongly recommend the taking of a tool inventory at least every 5 years, so that the tool accounts may be periodically put upon a known basis. Of course, whenever a tool room is maintained, the annual inventorying of tools is a common practice, and, if the client does this, the auditor should make it a practice of testing out the tool list against the existence of the tools. This examination by the auditor is not a waste of time, even when it is carried down to checking up a single saw. If a clerk expects and wants to be checked up (as is generally the case), as a matter of pride because his work is in A-1 condition, the auditor can well afford to spend a small amount of time on him, for otherwise the clerk's work will most certainly deteriorate.

445a. The Balance Sheet Valuation.—If the tool accounts are kept under any one of the above three methods, or under any other satisfactory plan, the auditor is justified in using the account balance (less reserves) for the balance sheet. For a going concern, cost less adequate depreciation is the proper valuation basis. Market values are of no importance for this purpose, unless there has been a major change in the general price level.

445b. The Balance Sheet Presentation.—The tool accounts are obviously an item under Plant Property. Under some methods of accounting for the tools, there will be no Allowance for Depreciation; but if there is one, it is correct to show it as a deduction from the asset rather than as a Reserve on the liability side.

B—FURNITURE AND FIXTURES

446. The Composition of the Account.—Under the caption of furniture and fixtures, one may properly include tables, chairs, cabinets, desks, floor rugs, typewriters, safes, bookcases, counters, computing machines, show cases, shelving, and so on (Plate 144). The invoice cost of each one of these assets plus freight, cartage, and installation costs, if any, are proper charges to the account.

As a rule, most all alterations and changes of partitions are entirely or largely profit and loss charges, because they do not increase the revenue capacity of the business or the real worth of the offices. In the final analysis the auditor will generally find that whims or convenience alone have caused most of these alterations. On the other hand, if partition alterations are made at the outset to a newly acquired piece of property, the expenditures are very apt to be proper capital additions.

On occasions the auditor will find that numerous items which could have been properly capitalized have been expensed. If this procedure is sanctioned by the client, the auditor should not object if he is satisfied that no one is being deceived or damaged thereby. His report should, however, contain a sentence of comment on it.

Credits to the account must be at cost. On some engagements the auditor will find or recommend the practice of keeping track of the additions by years so that they may be written off just as rapidly as they become fully depreciated. Under this method, if a retired asset is found to apply to a year that has been fully depreciated and hence already wiped off the accounts, no book entry is required except to credit the scrap value received, if any, to Miscellaneous Other Income. If the retired asset applies to a year that

\(^1\)Such items should be in the building account.
is still alive, the usual adjustments must be made to the asset and allowance accounts, if such retirement is due to fire, obsolescence or other unexpected cause. If the asset has had a normal useful life, it may be charged in total (less salvage if any) to the allowance account.

If the premises are leased, the auditor may have to establish at least two accounts for depreciation purposes; namely, one for those items which will not be able (or worthwhile) to be taken away at the end of the lease and one for those items which are movable and useful in another location.

447. See Plate 144.

448. The Verification Procedure.—As with other fixed assets, one of the auditors chief duties is to see that all entries are properly substantiated by approved vouchers or by requisitions and time cards, etc. Only on rare occasions will an auditor ever try to account for the individual physical items themselves, but he ought always to feel that the account is not inflated and that from the appearance of the physical items, adequate provision for depreciation is being and has been set up. However, it is not unknown, though of course very rare, for a client to take an inventory of these items at long intervals.

The verification of alteration charges is largely confined to ascertaining by personal inspection that in fact the alterations have added real value to the offices.

The amount of fire insurance which is being carried is useful at times in confirming to the auditor his opinion as to the real value of the furniture and fixtures.

The writer believes that no better verification procedure can be adopted by an auditor than to ask himself in the case of each and every entry to the account, "Is this a real addition or is it a replacement?" Naturally, if the item is a replacement, the asset and the allowance accounts must each be relieved of the values applicable to the retired item. If, however, the date of acquisition, or the cost of the retired asset can not be ascertained, the new item may be charged to the allowance if it appears to have cost about the same as the retired item. If the cost of the new asset appears to be widely different from the cost of the old asset, the old asset must be retired from the allowance and the asset accounts at estimated cost, no gain or loss on the retirement being recognized as a rule. Apply the same sort of questioning when analyzing the credits lost a new item be wrongly expensed.

449. The Balance Sheet Valuation.—Furniture and Fixtures should be valued at cost with allowance for accrued depreciation. At times an auditor will find that the account has been written down to practically nothing. This value may be used on the balance sheet even with an unqualified certificate, provided the auditor is satisfied that it is simply a case of unsharaful conservatism. But if, for example, he learns toward the belief that the officials are trying for personal gain, or otherwise, to depress stock quotations by making as poor a showing as possible in all departments of the business, the auditor must not sanction the procedure.

On rare occasions, such as on the retirement or admittance of a partner, or on the incorporation of a partnership, or on re-incorporating, or merging, the proper valuation may be at reproduction cost less accrued depreciation. Outside of such instances, furniture and fixtures are not often set up at appraised values, unless, indeed, there has been a major change in the general price level.

In regard to accrued depreciation, the annual rate is often controlled by the fact that the premises are being leased. If any of the fixtures are in reality real property, inasmuch as they have been securely attached to the

1Assuming unit method of retirement is being used.
A SCHEDULE ON OFFICE FURNITURE AND FIXTURES

Robertson Cotton Batting Co.
Office Furniture and Fixtures
Audit for the Year Ending November 30, 1929

<table>
<thead>
<tr>
<th>Balance per our papers and G/L 11/30/26</th>
<th>2349.12</th>
</tr>
</thead>
<tbody>
<tr>
<td>V-117 1 Desk for Miss Peterson</td>
<td>105.00</td>
</tr>
<tr>
<td>Freight</td>
<td>10.17</td>
</tr>
<tr>
<td>V-381 S &amp; M Co steel filing cabinet #8181M</td>
<td>189.00</td>
</tr>
<tr>
<td>Cartage</td>
<td>5.00</td>
</tr>
</tbody>
</table>

Omissions

<table>
<thead>
<tr>
<th>Omissions</th>
</tr>
</thead>
<tbody>
<tr>
<td>CB 89 (1 B A M Co adding machine - replaced by the machine on (V-467 above.</td>
</tr>
<tr>
<td>Cash $15.00</td>
</tr>
<tr>
<td>Res. 435.00</td>
</tr>
<tr>
<td>Total 450.00</td>
</tr>
<tr>
<td>Cost 435.00</td>
</tr>
<tr>
<td>P&amp;L $15.00</td>
</tr>
<tr>
<td>JV181 (S &amp; M Co steel filing cabinet #123 D - replaced by the (one on V-381 above</td>
</tr>
<tr>
<td>A Rec. $30.00</td>
</tr>
<tr>
<td>Res. 175.50</td>
</tr>
<tr>
<td>Total $205.50</td>
</tr>
<tr>
<td>Cost 195.00</td>
</tr>
<tr>
<td>P&amp;L $10.50</td>
</tr>
<tr>
<td>V-762 FIM Co. - 8 chairs for directors' room</td>
</tr>
<tr>
<td>Not additions 493.00</td>
</tr>
<tr>
<td>783.45</td>
</tr>
</tbody>
</table>

Balance per G/L 11/30/29

Audit Procedure

Vouchers for each item were examined in so far as indicated in the "date" column. All items were proper capital charges and credits to this account.

Possible Adjustment

Miss Peterson's old desk costing $85 in 1920 has not been eliminated. Sold for $5, the credit being to Miscellaneous Income. O.K. - See adj. $17 M.P.

447. Explanation and Comments. -- Note the wording of the opening sentence of this schedule. It will be recalled that the senior auditor generally places the heading on all schedules, and lists the opening balance. These figures are taken from the working papers of the last audit. It is then the duty of the one who prepares a schedule to see that the ledger begins with this opening balance. If the schedules are not opened with the figures from the prior audit papers, the auditor is not making certain that the opening balances of the accounts are the same as when he left them at the end of the last audit. For example, certain adjustments may not have been adopted, or they may have been misunderstood or overlooked, and so on. Moreover, if this procedure is not adopted, an account which was open on the last audit date might be entirely overlooked if it were closed on the present audit date.

Note also that Briggs (a semi-senior) made a notation as to a possible adjustment. This suggestion was adopted by the senior-in-charge (Mark Prescott), being embodied in auditor's adjustment #17. The adjustment itself will be entered on Schedule E, not on this one (25).

If the suggested and/or other notes are numerous, it is better for them to be written up by the junior (or semi-senior) who is analyzing the account on a separate sheet headed "Memoranda on . . . . . . " (here Memoranda on Office Furniture and Fixtures).
premise, or if they are of no use elsewhere, they must be written off over the life of the lease.

450. The Balance Sheet Presentation.—The Furniture and Fixtures account is, of course, an item of Plant Property.

451. See Plate 145.

C - DELIVERY EQUIPMENT

452. General Discussion.—Delivery Equipment should be segregated into at least several accounts, such as Autos and Trucks, Horses, Wagens, Harness, Carriers and Containers, etc. This is desirable because their respective rates of depreciation are very apt to be considerably different, and because it is much easier to check the accounts against the existence and values of the physical units represented by the accounts than if there was but a single Delivery Equipment account.

In the case of horses, autos, trucks, wagons, and the like, the best method of establishing their periodic value is by means of an appraisal. It is not very satisfactory to use a flat rate of depreciation. Moreover, it may be interjected here that the taking of such an inventory is far from being burdensome.

On each engagement the auditor ought to keep track of the number of units of each type of delivery equipment. The result should check against the number of actual physical units inspected. In addition, the auditor should satisfy himself that the accounts are not over stated, by dividing the balance of each account by the number of units it represents. The value thus secured should tally with the auditor's impression of what he saw on his inspection tour.

D - CARRIERS AND CONTAINERS

453. General Discussion.—Bottles, cracker tins, baskets, kegs, casks, barrels, and the like, are properly included under the heading of Carriers and Containers, provided they are containers which the customers are to return. Containers which are not returnable, and hence whose price is included as a cost of the article sold, should be kept in a separate account. Tin cans, bottles, and certain wooden and cardboard boxes are examples of this latter type of container. They are properly listed as Containers under the main caption of INVENTORIES. The difference between these two types of containers is this: those containers which are returnable are a fixed asset and are subject to very rapid depreciation, breakage, loss, and theft at the expense of the client; whereas the tin cans, and the like, are sold, their cost being included as a portion of the cost of the commodity.

Under one method of handling the account, the debit entries will be for all purchases, and the credit entries will be for the portion written off as expense. This expense, representing depreciation and losses, should be based on the experience of a number of years. The rate will always be high, and more so if no temporary charge is made to the customer for the container. The debits to the account must be supported by proper vouchers. If the containers are of high value, the balance in the account may be simply a physical inventory extended at a sound value of one-half the original cost, on the assumption that the containers are in all stages of depreciation ranging from 0 to 100%.

Some auditors exclude from inventories those containers whose function is to preserve the enclosed articles from damage during shipment. Such containers are set up as SHIPPING SUPPLIES under prepaid assets. This procedure is taken because shipping supplies do not enter into the cost of the finished product.
## A Schedule on Furniture and Fixtures, and Reserve for Depreciation Plate 145

### Jones, Hadley and Jones

(1) Furniture and Fixtures and (2) Reserve for Depreciation 2-15-30

Audit for Year Ending Dec. 31, 1929

<table>
<thead>
<tr>
<th>(LEFT SIDE)</th>
<th>Rate 10% per annum</th>
<th>Total 15%</th>
<th>25%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>12/31/29</td>
<td>1929</td>
<td>1927</td>
</tr>
<tr>
<td>Property - per our papers and G/L 12/31/28</td>
<td>17864.48</td>
<td>50.00</td>
<td>4856.32</td>
</tr>
<tr>
<td>Less - fully depreciated property at 6/30/29</td>
<td>2307.12R</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additions for 1929. See Fl-a for details</td>
<td>23.18</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deductions</td>
<td>349.52R</td>
<td>50.00</td>
<td>4856.32</td>
</tr>
<tr>
<td>Balance 12/31/29 T</td>
<td>15235.02</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Reserve For

<table>
<thead>
<tr>
<th></th>
<th>6809.70</th>
<th>2.50</th>
<th>728.45</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2307.12R</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total additions at 10% per annum</td>
<td>1654.13</td>
<td>5.00</td>
<td>465.63</td>
</tr>
<tr>
<td>1929 additions at 5% ( \times ) .05</td>
<td>1.16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deductions</td>
<td>349.52 ( \times ) 7 yr. ( \times ) 10%</td>
<td>244.66R</td>
<td></td>
</tr>
<tr>
<td>Balance 12/31/29</td>
<td>5913.21</td>
<td>7.50</td>
<td>1214.08</td>
</tr>
</tbody>
</table>

## Operation of the Account

As soon as a reserve reaches the full amount of the asset value for that year, no further depreciation is taken, of course. Moreover, the asset is charged against the reserve at this time. Whenever a physical unit is scrapped, its date of installation is ascertained. If that date is for a year in which the assets have already been written off against the reserve, no entry in either the asset or the reserve accounts is needed to record this transaction. But if the date concerns a year in which both the asset and the reserve accounts are alive, then the usual adjustment for the retirement of an asset is necessary as of the middle of the year, i.e. June 30th.
705.62 1914.24 670.13 444.47 111.69 42.64 2191.76 2307.12R
281.45 546.93 148.92 50.90X 14.92 5.02 115.36
244.66R
885.07 2461.17 619.05 250.71 126.61 47.56
R ( RED )
X 683.76 x 10% x 1/2 equals
683.76 minus 349.52 equals 334.26 x 10% x 1/2 equals 34.189
349.52R
Reserve - Opening Balance 12/31/28 6809.70
Assets - 17869.48 x 10% 1786.95
Net Additions 2632.46R x 5% 131.67R
T 15236.02 8464.96 Total
Loss Charges 2551.70
Reserve - Balance 12/31/29 5913.26

451. Explanation and Comments.— This exhibit shows a method for preventing over depreciation by keeping track of the asset and the reserve by years.

As stated under Operation of the Account, the additions and deductions in the asset account are handled as if they occurred at the middle of the year.
Whenever there is no charge made for containers, but it is expected of the customer that he will return them, extra debit and credit columns in the personal ledger accounts may be used to keep track of the containers loaned and returned.

Cost less an adequate depreciation allowance for wear and tear, breakage, and loss is the proper balance sheet valuation for returnable containers; but cost or market, whichever is the lower, is the proper basis for those containers which are true current assets. Of course, both these valuations are based on the supposition that the client is a going concern, that the containers are in reasonable quantities, and that they are being used. If they are not being used, or if they are in excessive quantities, the excess quantities must be valued at scrap or greatly reduced prices.

In the case containers are charged to the customers with the privilege of returning them at cost, they must be kept track of in a separate account. It is incorrect to credit as a sale the whole price charged to the customer, and it is likewise incorrect to treat as a current asset the total of the Accounts Receivable account.

**EXAMPLE**

(Assumptions)
(1) Purchased 45,000 containers at $50 each. These are temporarily charged to the customer at cost with the privilege of returning them at cost.
(2) The sales during the year were 345,000 units at a gross price of $253 each.
(3) There was received on account during the year $63,945,000 and 315,000 containers.
(4) The depreciation rate is 20%.

**Entries**

| Containers | $2,250,000.00 |
| Cash | $2,250,000.00 |
| **To record the purchase of 45,000 containers at $50 each.** |

| Accounts Receivable-Trade | $87,285,000.00 |
| Sales | $70,035,000.00 |
| Containers Out | $17,250,000.00 |
| **To record the sale of 345,000 units at a gross price of $253 each.** |

| Cash | $62,945,000.00 |
| Containers Out | $15,750,000.00 |
| Accounts Receivable-Trade | $79,695,000.00 |
| **To record the receipt of the above cash on account and 315,000 containers.** |

| Container Expense | $450,000.00 |
| Depreciation Reserve-Containers | $450,000.00 |
| **To write off depreciation at 20% per annum on the original cost of $2,250,000.00.** |
Balance Sheet Computations

Accounts Receivable account - debit balance $7,590,000.00
Loss-Containers Out account - credit balance 1,500,000.00
Amount for Balance Sheet as Trade Accounts Receivable $6,090,000.00

Containers account - debit balance $2,250,000.00
Reserve for Depreciation-Containers account-Credit balance 460,000.00
Amount for Balance Sheet as Containers $1,800,000.00

E - MOLDS, PATTERNS, DRAWINGS, AND DIES

454. General Discussion.—Within this category fall such items as electrotypes, patterns, lasts, designs, molds, drawings, dies, wood cuts, forms, and the like.

If the useful life of any item is clearly limited to the order for which it was made, its value must be charged to it as a cost thereof. On the other hand, if the item applies to a product which certainly will be produced a number of times in the future, its cost should be capitalized, albeit written off very rapidly. Usually the major portion of the cost can be readily absorbed by the first publication, first year's sales, etc., as the case may be. If it can not be thus absorbed, there is great probability that the product is not a success,—in which case the necessity for writing off the account as a loss (not as an expense) is even greater than before.

It can not be emphasized too strongly that the periodic balances in the account should result from inspection, appraising, inventorying, analysis of pertinent facts, rather than from the writing-off of a certain "blind" percentage each year. The reason for this procedure should be obvious to everyone who gives a minute's thought to the transitory nature of these items. Obsolescence is usually the main factor of depreciation. Changes in styles are extremely rapid. Public demands are notoriously fickle. Even engineers must make many alterations to keep up-to-date with competitors. In brief, annual inventorying is the only substantial method of establishing the values of these assets.

In verifying this account, the auditor must assume the "I'm from Missouri, show me attitude. Even then, he is none too well fortified for the struggle. Because of their optimistic views, clients invariably oppose any substantial reduction in these assets.

As a rule, the auditor can make no better beginning in his verification of this account than to ask to see, and thus to account for, the various physical items. If they are carefully stored and insured, the auditor may assume that there is some real foundation for carrying them as assets.

The next step for the auditor to take is for him to secure some evidence of the original cost and date of origin of each unit. If they were bought, approved vouchers must be examined. If they were made within the business, the cost sheet (or its equivalent) must be verified against material requisitions, time cards, and overhead computations. After this examination has been completed, the auditor then faces the difficult problem of checking the present inventory value of each unit. As an aid in

1.I.E. the remaining balance. 2 Of course, if in a particular case the life of an item is known with reasonable certainty, it should be written off in proportion to the year's production to which it applies, or by any other equitable plan. 3 "The amount of depreciation on patterns depends, among other things, upon a consideration of each of the following matters: (a) Kind of material the pattern is made of - wood, metal, etc., (b) Frequency of use, (c) Stability of style, type or model of the product, (d) Use of the patterns in the future for supplying repair parts for old models." —F.W.K.
this task, the auditor should list on his schedule, opposite each item, the current or recent orders calling for its use, and, on the strength of the size and frequency of these orders base his estimates of value.

If, in presenting this account on the balance sheet, it is placed along toward the last of the Plant Property items, it will be accorded fair treatment. As the values tied up therein are very fleeting—here to-day, gone to-morrow—, they obviously rank just one step ahead of the intangibles.

455. See Plate 146.

455a. Audit Program

(1) Tools.
   (a) Ascertain if the client's system of accounting and physical control over tools is adequate. Make recommendations.
   (b) Get the client to carry different accounts for hand and machine tools respectively, assuming that the client will not go any farther than this elementary division in arriving at proper depreciation.
   (c) See that the accounts (and depreciation allowance, if any) are handled on a basis that is essentially accurate; vouch the additions. See that retirements are credited at sums originally charged in. See that the allowance account is adjusted for retirements.
   (d) See that the client takes a physical inventory at least every 3 to 5 years, and adjusts the book figures to it.
   (e) Ascertain to what extent obsolescence is an important factor. If important, see that the client is using proper methods to ascertain and record it.
   (f) Tools made by the client for itself should not absorb any of the general factory overhead, unless the plant is operating below capacity. Under no circumstances should profit be taken up on these tools.
   (g) Make a general survey of the tools themselves. Estimate their value and condition; compare with carrying value. If the discrepancy is large, investigate further.
   (h) When a tool room is maintained, test the list of tools against the existence of the tools. See that the total of the list agrees with the controlling account. Test prices to recent purchase invoices.

(2) Furniture and Fixtures.
   (a) Permit the client to expense small capital additions if in your opinion no one is being materially deceived or damaged thereby. However, comment on it in the audit report.
   (b) Most alterations and charges of partitions (really a part of the building account) should be expensed. New partitions are capital additions.
   (c) If promises are leased, see if the life of the lease controls the depreciation rate of those items which can not be (or worthwhile) taken away.
   (d) When a composite rate of depreciation is being used, see that items retired for special reasons (such as for fire, obsolescence, etc.) are charged to the allowance for depreciation only to the extent of the depreciation accumulated to date. Other retirements are chargeable in full (less salvage value if any) to the allowance account.
   (e) Do not recommend that a property ledger be installed or annual physical inventory be taken unless for special reasons or unless the client is one whose accounting system is modern in every respect.
   (f) Compare amount of fire insurance with carrying value. Compare what your eyes see with the amounts in the asset and allowance accounts. If the discrepancy is large, investigate further.
   (g) When vouching the additions to the account, ascertain which
items are replacements. See that for each of these a retired item has been credited to the account and debited to the allowance account. See that the credit is the same sum as was originally charged in at date of purchase. (Assuming unit method of retirement).

(b) When analyzing the credits to the account, ascertain which items have been replaced. See that those have been capitalized, NOT expensed. (Assuming unit method of retirement is being used).

(1) Develop asset and depreciation accounts on same schedule, if feasible.

(3) Delivery Equipment.
(a) Get the client to set up several properly classified accounts.
(b) Do not use flat rates of depreciation; use physical appraisals to establish values.
(c) Wherever practical keep track of your work sheet of the number of units. Check to the number on hand. Divide the balance of the asset account by the number of units to see if the average value is reasonable.
(d) Apply procedures in #2 above whenever applicable.

(4) Carriers and Containers.
(a) Distinguish between returnable and nonreturnable containers. The former are fixed assets subject usually to rapid depreciation, breakage, loss, theft, etc., The latter are "inventory" being included in the cost of the commodity sold.
(b) If no temporary charge is made to the customer for the returnable container, the rate of depreciation and loss will be higher than otherwise.
(c) If the containers are of high value, secure their worth by physical appraisal, or physical count. In the latter case carry each one at one-half cost.
(d) When no charge is made to the customer for the returnable containers, ascertain if it is feasible to keep track of them by some such method as having extra debit and credit columns in the sales ledger accounts (for this purpose).
(e) When a charge is made to a client for a returnable container, exclude it from accounts receivable in a balance sheet presentation. Exclude also from sales.
(f) Cost less an adequate depreciation allowance for wear and tear, breakage, and loss is the proper balance sheet valuation for returnable containers; but cost or market, whichever is the lower, is the proper basis for those containers which are true current assets.
(g) Always divide the asset balance (gross figure) by the average unit cost to determine the number of units involved. Is this number reasonable when compared with the size of the client's trade, etc., etc.?

(5) Molds, Patterns, Drawings and Dies.
(a) Any item made for a specific nonrepetitive job (sale) must be charged to that job. The same is true of items made to effect repairs to machinery or for special construction work, items made for experimental or sales departments, etc.
(b) The carrying values should result from inspection, appraising, inventorying, analysis of pertinent facts, etc. rather than from the application of depreciation rates, etc.
(c) Obsolescence, NOT wear and tear, is usually the controlling factor in determining carrying value.
(d) See the physical items for which value is being carried. Ascertain if they are being carefully stored and insured.
(e) Keep track of each item SEPARATELY on the audit schedule. Show opposite each the basis or reason for carrying any value for the item.
### AN OUTLINE OF A SCHEDULE ON MOLDS, PATTERNS, DIES, ETC. PLATE 146

**SHACKLETON, WATJEN & LEWIS**

Molds, Patterns, Drawings, Dies

Audit for Quarter Ending Feb. 28, 1930

<table>
<thead>
<tr>
<th>Description of Products Using These Patterns, Etc. Molds, Etc.</th>
<th>Date</th>
<th>Amount</th>
<th>Value</th>
<th>Inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929 Sales</td>
<td>Cost of Molds, Etc.</td>
<td>Inventory</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Full</td>
<td>2/28/29</td>
<td>2/28/30</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

455. Explanation and Comments.—In the writer’s opinion, a schedule of this type should contain at least a careful description of the items; a record of the sales of products using these molds, dies, etc. (as an aid in determining if the item is alive or obsolete); the cost and date of purchase; and the inventory value assigned at the last audit date.
1. Why should hand and shop tools be kept in a different account from machine tools?
2. Should you verify the existence of the articles called for by the furniture and fixtures account?
3. What kind of containers can be properly classified as current assets?
4. When is it proper to use the appraised sound value of the furniture and fixtures?
5. What bearing might a lease have upon the rate of depreciation of an asset?
6. Give the accounting entries to keep track of containers which are charged for, but with the privilege of being returned.
7. Give the balance sheet presentation of these accounts.
8. How would you verify the balance of an account entitled Autos and Trucks?
9. How would you check up on the value of the Containers account?
10. How would you go about auditing molds, patterns, drawings, and dies?
11. How would you treat alterations of partitions if the property has just been acquired?
13. Describe the workings of a good tool room.
14. How would the auditor check up the correctness of the account balance under each of the three methods outlined in question 12?
15. What is the proper classification of accounts for delivery equipment of various kinds?
16. If you found that some articles of furniture and fixtures had been knowingly expensed, what would you do about it?
17. How would you keep track of containers which are being constantly loaned and returned without charge?
18. What is a common rate of depreciation for containers?
19. What is your opinion of the following:
"Where the total expense for patterns runs fairly constant year after year, and where such charges are incurred in acquiring or producing new patterns to replace others which have worn out or have become obsolete, the investment in patterns may be fixed at a certain amount in the account and the yearly charges written off to expense. In such instances a depreciation reserve need not be established since the replacement expenses make good the wastage." - F. Kilduff.
456. General Discussion. — Intangibles; that is, copyrights, trade-marks, formulae, goodwill, franchises, patents, privileges, and so on, should be classified on the balance sheet in a group by themselves (1) because they ARE intangibles, (2) because they are very often infinitely hard or impossible to value, (3) because they are usually of little or no value if the business ceases to operate, (4) because their value fluctuates widely within very brief periods of time, and (5) because they are apt to be "watered" accounts. Therefore, to repeat, since the values represented by these intangibles may be valued at radically different amounts, even by experts, they ought to be segregated by themselves so that those who have to deal with the balance sheet may know that after all is said and done, it is up to them individually to value these assets for themselves.

As a matter of history, these assets have often been watered to balance out capital stock which has been issued indiscriminately. However that may be, it should never be held that these items are always valueless. Indeed, they are sometimes more valuable than the tangible assets. The stated goodwill of many businesses is often but a mere nominal part of the value of their real goodwill. Everyone should know that goodwill may be a tremendously valuable asset when it actually exists. The same proposition is true of patents and formulae. Many enterprises are valuable only in so far as their patents are protected, or their formulae are kept secret. In summary, then, although intangibles are often watered, they are also often leading assets. It must be emphasized that notwithstanding the fact that intangibles are hard or impossible to value, and even though their value on the balance sheet is not their real value, it is, nevertheless, the duty of the auditor to see that certain recognized fundamental principles of accounting and auditing procedure are applied to these assets. What those principles are will be developed in the treatment of the various topics falling within this chapter and the one following.

457. Trade-marks. — A trade-mark is a symbol, or mark, the purpose of which is to make a product more readily identifiable by customers. It is the equivalent of a signature. Thus a certain Eskimo scene on bottles is sufficient to identify the product as Clicquot Club ginger ale. Obviously, a trade-mark may be a tremendously valuable asset, once the buying public has been sold on the idea that it stands for quality merchandise at low cost,—which is not to say that the representation is not true.

If the trade-mark is registered and used continuously, it is secure for thirty years, after which time it can be renewed for another thirty years, and so on. The value of registering one's trade-mark with the federal govern-

1 One common test as to the value of a business is to ascertain the rate of "interest" earned by the enterprise on its tangible (accounting terminology) assets, by dividing the Gross Income (or Net Profit on Operations) by the tangible assets.
ment lies in the fact that priority of use is thus readily legally established. But other than this, there is no need for registering it with the government. That is to say that it could be registered with any private organization conducting the business of registering trade-marks.

Unless the idea behind the trade-mark has been purchased, the direct outlay on it will be insignificant. The general situation is that the inherent goodwill value of the trade-mark will have been developed by advertising. Although enormous sums may have been spent for this purpose, these expenditures must not be capitalized. Only DIRECT costs involved in developing, purchasing, and defending a trade-mark may be charged to the account.

Although a trade-mark is not subject to amortization like a patent, it is often written down to a nominal value - often as low as $1,- because its value fluctuates with the ups and downs of the business itself, and because it becomes valueless at the cessation of the business.

Any expenditures entered in the account must be vouched and found to be proper capital additions in accordance with the principles outlined above. Moreover, the auditor should call for the document evidencing the registration of the trade-mark so that if none exists, he can point out the urgent advisibility of getting one.

456. Patents.—Whenever a patent is purchased for cash, the legitimacy of this value in the account is readily admitted. On the other hand, if a patent is paid for with capital stock the problem is: At what value shall the patent be entered in the books of account? In such instances the par-value or average paid in value, if it is no par-value stock, must often be allowed by the auditor to represent the value received for each share issued, even though the market value may be widely different (either above or below) from this figure. If the auditor is asked by the client to handle the matter correctly, he will, of course, value the patents at the market value of the capital stock issued therefor. At times even this task is a difficult or impossible one, as when the company is practically a closed corporation, or when the stock is that of a brand new corporation. But as a rule, no such request will be made to the auditor. Therefore, he must allow the par value, average paid-in value, or other value, to stand, since the law permits a board of directors to handle this matter in its own way, provided fraud is not involved in it.

On some occasions, the auditor will find that the patents have been developed by the client itself. If so, the auditor may find one of the two following methods of valuing the patents. First, the total expenditures incurred by the experimental laboratory for the year may be prorated equally, or otherwise, over the useful patents developed or partly developed during the year. This method of handling the expenditures is entirely incorrect, and would be so even if the total expenditures were prorated to the various patents on a weighted basis; i.e. on the ground that this patent is worth twice that one, and so on along the line. According to the writer’s way of thinking, each patent should be considered as a distinctly different project. If nothing comes of the time, materials and overhead spent in developing a particular patent, the costs thereof must be looked upon as a total loss or expense. Those who hold to the first plan often say this in rebuttal. If, for example, in the course of completing an order of 100 bolts for stock only 97 pass the inspection department, the unit cost of each of these 97 perfect bolts is the sum total cost expended on the 100 bolts divided by 97. This point is absolutely correct in the case of these

1 Of course, if the trade-mark is not going to be renewed, its value should be written off the books on an amortization or other basis.

2 Loss, if the concern is NOT in the business of making patents; expense if it is.
bolts and similar cases, but it does not apply to the developing of patents. Each patent is an entirely different project from its neighbor, whereas each of the 97 bolts is exactly like its neighbor and a part of the same order. Therefore, to repeat, as the development of each patent is a special undertaking (one patent being as different from another as day is from night), the cost of unmaterialized patents is an irrelevant fact. The correct method, therefore, would seem to be the one whereby only the actual labor, materials, and overhead spent upon a successful patent are capitalized as the SOLE cost of that patent.

Since a letter of patent from the government does not guaranty that the patentee shall have the uncontested use of his patent, any costs incurred in defending the patent are chargeable to the account; provided the case is won. If the suit is lost, the expenditures for legal fees, and the cost of the patent, must be treated as losses or non-operating expenses. On the other hand, if damages are secured, they must not be credited to the patent account, but rather to surplus or non-operating income.

If an auditor should have a client who has bought a patent in order to eliminate competition, or in order that he may not have to scrap his own valuable organization, or valuable machinery, etc., the auditor must allow the expenditures as capital additions to the patent account.

As the legal life on a mechanical patent is seventeen years, its value must be written off during and within this period, if indeed it is actually useful that long. This process of writing down the value of an asset on the basis of time, as distinct from the basis of wear and tear, is called amortization, and the amount is generally entered as a credit direct to the account, rather than to an allowance for amortization.

As alluded to just above, a patent is fortunate indeed if it lives out its natural legal life. Supersession and obsolescence are very dangerous enemies to such a possibility. As a matter of record, most patents are either overtaken by a better invention, or are left stranded by a change of fashion or demand. Of course, it is difficult to forecast in just what year this obsolescence will take place, but the chances are 1000 to 1 that obsolescence will take place. Therefore, some genuine attempt must be made to make a forecast of it. At any rate, there is no possible excuse for not writing off the account as soon as the supersession or obsolescence has occurred.

In some few instances the patent will outlive its natural life in this sense; namely, that the position of the client is practically as secure without as with the patent, because of the tremendous goodwill which has been built up during the legal life of the patent. Even though this be true, it could not be foretold with certainty at the outset seventeen years ago. Therefore, the natural ordinary procedure of writing off the account annually must be adhered to in all cases. Moreover, it is incorrect to re-establish the patent account, or any account whatsoever, for this goodwill, even though the goodwill effect of the patent be conceded to be of great value. Goodwill must never be set up on the books of account simply because it exists. For accounting purposes, some transaction must bring the goodwill into existence. No injustice is done to the client by insistence on this procedure, because the sophisticated person will always ignore the stated value of the intangibles and measure the value of the business for himself by some such method as a comparison of the profits with the amount of intangible assets employed. (See the former Federal Reserve Board form 28-3)

This is based on the reasoning that the client is the best judge as to whether or not the patent is worth being continually defended. If the client is willing to spend "good Cash" in defending a patent, that is ORDINARILY a sound reason for capitalizing the expenditure. However, care must be exercised to see that ludicrous values do not result therefrom.
of balance sheet for its treatment of Goodwill)

If an auxiliary patent is secured, whereby the life of the basic patent is renewed, the existing value of this date of renewal may be written off over the TOTAL remaining life; but read also section 419 for an optional, and perhaps better procedure.

Any royalties which may be paid for the use of a patent must never be capitalized; unless, indeed, there is a valid option whereby the client may apply these payments to the cost price should it elect to purchase the patent. In such an instance, the auditor must make certain that the client fully intends to make the purchase. Even then the better method is not to capitalize the payments as they are made, but to set up the asset and the liability accounts in full, charging the payments to the liability account.

Another problem arising out of this question of the proper treatment of patents is that of the proper location in the profit and loss statement of the amortization charge. Logical analysis leads one to the conclusion that if the patent applies to the manufacturing process, the amortization charge is a cost to manufacture; but if the patent is on the idea of the article itself, the profit and loss charge is a proper selling expense. Such a patent, by giving a monopoly of the article, protects the selling price.

If at any time the auditor should find an account labelled "patents", whose sole reason for existence is that it is necessary in order to balance-up an issue of capital stock, he must refuse to pass it under this caption. Whatever the account may properly turn out to be in a particular case, it is clearly not patents, and any sanctioning of this term by the auditor is equivalent to aggressive concealment,—which is actionable fraud.

Due to the time which elapses between the date of making an application for a patent and the date of its being granted, if at all, another problem arises. Thus, if the applicant for a mechanical patent was made on January 1,1927 and finally granted on January 1, 1929, the 17 year term would run from 1929. From a "hindsight" point-of-view, the patent should be written off from 1927 at 1/19 (NOT 1/17) of its value at that date, but from a "foresight" point-of-view these facts were unknown in 1927. For this reason it has been proposed that the proper method is to allow the account to stand at its original value until such time as the patent is granted, from which time forth 1/17 of the cost should be written off annually. Obviously, this procedure is wrong since it proposes to do nothing between the date of application and the date of issuance of the patent, simply because 100% accuracy can not be secured. If 1/18 or 1/19 of the original cost is written off annually until such time as the patent is granted, and then if the balance at that time is written-off in the next 17 years (assuming the patent to be valuable that long) substantial accuracy will be secured. For those who desire strict accuracy, or whenever the sums involved are substantial, the patent account could be adjusted at the time the patent is granted in view of all of the facts then definitely known. Thus, in our example above, the entry would be as follows:

1Errors of this kind have often been uncovered when the auditor asked the client for the letter-of-patent.
2Opportunity is again seized to EMPHASIZE that many, perhaps most, patents are valueless long before the end of 17 years, the legal life. The auditor should always test each patent against the amount and profitability of the sales of the product using it. 4Assuming production is started immediately after the patent is applied for; otherwise not.
January 1, 1929

Patents

Surplus 899.53

To adjust the Patent account on the basis of a total life
of 19 years, i.e. Jan. 1, 1927 - Jan 1, 1946

2/18 of $153,819.54 (cost) equals # $17,091.06
2/19 of $154,819.54 (cost) equals ## $16,191.53

# Amount charged off in 1927 and 1928, the estimated life being 16 years.
## Correct charge for 1927 and 1928 on the basis of the facts now known,
i.e. 19 years.

Of course, this adjustment has been naively based upon the assumption
that the patent will have a life of 19 years when, as a matter of fact,
the weight of experience shows that supersession and obsolescence will more
than likely upset these fine calculations. Therefore, the theoretically
inaccurate method of writing off 1/17 from the date of application will
very likely give results which are nearer the true facts for most patents.

Although it is advisable to keep a patent account in the general
ledger, and an individual record of each patent in a subledger, no great
harm is done if the patents are placed on the balance sheet as Good-
will, Patents, and Trademarks. In this connection it may be remarked that
it is very rare indeed to see an allowance account for patents. The amorti-
zation is usually credited direct to the patent account.

Whenever a patent is bought for cash, the auditor will expect to see
a proper voucher and a cancelled check. If the patent has been secured by
an issue of capital stock, the auditor, in addition to reviewing any vouchers
thereon, must also scan the directors’ minutes for the authorization thereof.
The letter-of-patent must always be examined.

As was emphasized previously, if the client has developed the patent,
the auditor must satisfy himself by inquiry, and by a personal examination
of the material requisitions, time cards, and overhead computations, that
each successful patent has been capitalized at its own individual cost only.
Obviously, if there are not proportionately large amounts in the Patent
Development Expense account, it is almost a sure sign that the expenditures
on unsuccessful patents are being capitalized.

The balance of the Patents account must be broken down through a sub-
ledger, or otherwise, into amounts identifiable with specific patents.

459. See Plate 147.

460. Copyrights.— As those principles which were elaborated in the
discussion of patents are largely applicable to copyrights, no extended
treatment of this topic will be offered.

A Copyright is a monopoly grant given by the federal government for
28 years. This privilege may be renewed for the same term, provided an
application is entered within six months of the expiration of the original
grant. Through this security, authors, musicians, artists, publishers, and
others, have an exclusive right to make and sell their literary, musical,
or artistic creations.

If the auditor’s client is a publisher, the cost to it of copyrighting
a book to be published for an author on a royalty basis is not much more
than the nominal fee paid to the government. But if the publisher purchases
outright a copyrighted manuscript, its cost may be considerable, and it is

Use date of grant, if production does not begin until then.
Audit for the Two Years Ending Dec. 31, 1929

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<th>Cr.</th>
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</tr>
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<td>49</td>
<td>375.00</td>
<td></td>
</tr>
<tr>
<td>52</td>
<td>375.00</td>
<td></td>
</tr>
<tr>
<td>81</td>
<td>975.00</td>
<td></td>
</tr>
<tr>
<td>83</td>
<td>450.00</td>
<td></td>
</tr>
<tr>
<td>Total additions in 1928</td>
<td>13822.49</td>
<td></td>
</tr>
</tbody>
</table>

1928 - 1/2 year's amortization at estimated life of 10 years. 691.13

Vo. 2175 R.E. Jordan Legal fees Suit lost to Herrill, Inc. 4500.00

Balance per G/L 12/31/29 18322.49 691.13 691.13

Adjustment #12 (Dr. Surplus $17631.36) 17631.36

Final Balance 0

Audit Procedure

(1) Letter of Patent seen.
(2) All of the vouchers for material and labor, and the overhead computations were found to be correct additions to this account.
(3) On Dec. 24, 1929 the client lost its suit against Herrill, Inc.; thus the patent is valueless.

459. Explanation and Comments.— Note that this business has recognized the existence of obsolescence by setting the life of the patent at 10 years.

Also note the treatment of the account due to losing the suit against Herrill, Inc.
properly capitalized. So also, if the auditor's client is the creator himself, the value in his Copyright account may properly be the cost of the time, materials, etc. spent by him in developing the thing copyrighted.

It has already been emphasized that few patents live throughout their legal life of 17 years. It is now doubly emphasized that the value of a copyright is notoriously short lived. For this reason the auditor must insist on checking up each copyright against sales, or use other methods of estimating the probable life of the copyright. The cost of most copyrights should be entirely or largely absorbed by the income of the first edition.

The financial life history of each copyright must be kept separate on the audit papers. These latter must show the basis on which the cost is being written off, and the reasonableness of this basis as supported by current facts.

461. Franchises.—Although franchises are largely limited to the accounts of public utilities and similar enterprises, nevertheless, a few comments will be made thereon.

A franchise is "a privilege given by the community to a private person or corporation to use the public property for the benefit of the public, and only incidentally is it the intention of the community in granting such a right to allow the person accepting the same enough to insure his willingness to take advantage of it by investing in plant to make use of the grant."

If only regular periodic, say annual, payments are made for the franchise privilege, these expenditures must always be expensed. Only those lump sum payments, or equivalents, can be capitalized in the Franchises account. In addition to this, there are customarily legal and other incidental fees arising from securing the franchise. Less often, some property damages from condemnation and other proceedings may have to be paid to individual property owners whenever, in the attaining of the full benefits of the franchise, property rights are trespassed upon. However, amounts paid for definite pieces of condemned property must be charged to property (tangible) accounts. If the franchise rights are purchased from another business, the full cost thereof is clearly a proper charge to the Franchises account, provided the franchise is assignable to the purchaser.

The writing-down of the franchise account should engage the auditor's most careful consideration. If the privilege is perpetual, and if it will probably be used forever, no amortization needs to be written-off. But certainly no harm is done if it is written-off,—provided always that the facts are clearly stated in the balance sheet or the report. If the franchise is limited, this period may determine the rate of amortization if the project really has a life expectancy of at least that length. But if the project is likely to be abandoned before the expiration term, the approximate date of the abandonment must control the amortization rate. Finally, if the life of the franchise is granted only "during good behavior and may be terminated by the authorities at any time by paying the fair value of the property exclusive of the franchise", the auditor must urge the client to use a liberal amortization rate; i.e. one far higher than would otherwise be used.

In addition to verifying the account by means of approved Vouchers, paid checks, and directors' minutes, the auditor must always secure and abstract the terms of the franchise. If the auditor does not examine the

\[\text{Patents and franchises} \quad \$2,515,975.23\]
\[\text{Less-Reserve} \quad 2,515,974.23\]
\[\text{\$} \quad 1.00\]
franchise itself, he will not be certain as to the length of its life, nor will he know what fees are to be paid, nor what rates can be charged, nor what service is demanded, and so on. Obviously, certain of those terms have a very vital bearing on the amortization treatment to be given to the franchise account, and possibly to other accounts, such as Plant Properties.

If the franchise is purchased from another business, the auditor must make certain that the rights are indeed assignable. He may either secure a letter to this effect from the client's lawyer, or he may write to the original grantor of the franchise, or he may use any other equivalent procedure.

Franchises, being an intangible, are a proper item under the main caption of Intangible Assets. As a rule, the write-offs for amortization are not carried in a separate reserve account but are credited direct to the franchise account.

462. Formulae, Trademarks, Etc.--The reader must remember that a client will often possess various formulae and trade secrets of real genuine value without their value being stated in the books of account. This is often due to the fact that many such secrets are stumbled upon, rather than conscientiously and purposely developed. However, if any costs have been incurred in developing or purchasing a formula, they should be capitalized if material sums are involved.

Whenever an auditor has such an account as Formulae, Trademarks, Etc. before him for analysis, he must find out if the processes have been patented or otherwise legally protected. If they have not been thus protected, their value needs to be written off more rapidly than if they were protected. But in any case, whether protected or not protected, the auditor must never assume that the account can be carried along at cost. Obsolescence or supersession will most certainly condemn the process to the back ground or scrap heap within the course of a comparatively few years. The advances which science is making to-day, even in the course of five years, are enough to worry any manager (if he will let it), lest he wake up to find that the morning paper is announcing some discovery or other which bids fair to destroy over night his present ascendancy.

463. Electrotypes, Etc.--Closely associated to copyrights, but entirely different from them, are the electrotypes and plates themselves. In fact, the association is so close that often the only evidence on the accounting records of the existence of a particular copyright will be the account for the electrotypes, etc.

The common conservative practice is to write off the major portion of the cost of the electrotypes against the first edition. The initial sales of a successful publication can usually stand this cost. If they can't bear it, there is strong indication that future orders will be negligible. Therefore, there is every reason to insist on writing the account down now to its scrap value.

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1 But, where the account is written down in lump sums to a nominal value, such as $1, the reserve method should always be used and shown on each and every succeeding balance sheet. This is not in accord with current practice, but it is in accord with the best practice. See the General Electric Company illustration supra.

2 Where the work is a standard one, or in other special instances, the auditor should write off the account equitably over the entire number of copies marketed.
(1) Find to what extent, if any, the intangibles have been watered to balance out capital stock issues. Ascertain if the water can be squeezed out, or whether it must stand in accordance with present directors' minutes. Present the facts as to how the valuation has been established in the audit report.

(2) Trade-marks.
(a) See that the trade-mark is registered.
(b) Advertising expenditures must not be capitalized in this account. Only direct costs involved in developing, purchasing, and defending the trade-mark may be charged to the account.
(c) If the client desires it, the account may be written down to $1.

(3) Patents.
(a) If purchased with capital stock (or by other means than cash), ascertain the true cost as distinct from the recorded cost. If possible, adjust for any sizable difference.
(b) The development of each patent should be regarded as a special and distinct undertaking. Accordingly successful patents should not be saddled with the cost of unsuccessful patents worked upon concurrently.
(c) Examine the letters of patent. Ascertain by inspection if all patients have been properly assigned to the client.
(d) Legal costs of defending a patent are usually proper charges to the account, provided the case is won. If lost, the legal costs and the carrying value of the patent are losses. Care must be taken, when/if the law suits are numerous, and/or costly, to see that the balance of the account is not a ridiculous sum.
(e) Patents bought to eliminate competition may be capitalized, even if not used.
(f) Although a patent has a certain legal life (e.g., a mechanical patent - 17 yrs.), it must be written off during its useful life, if this is the shorter period.
(g) A patent written off, must not be reestablished because of the goodwill which it has created and left behind it. Neither should goodwill be set up.
(h) The life course of each patent must be kept separate on the audit working papers. These papers must show the basis on which the cost is being amortized, and the reasonableness of the basis as supported by CURRENT FACTS.
(i) If an auxiliary patent is secured, whereby the life of the basic patent is renewed, the existing value at this date of renewal may be written off over the total remaining life. A better method is to re-establish the correct present value of the basic patent in view of its extended life. The cost of the auxiliary patent and the expense incurred in getting it patented, are also capital charges to be amortized over the new life period.
(j) When a patent has been bought, see all agreements, contracts, etc. Examine directors' minutes, approved voucher, cancelled check, etc.
(k) Ascertain what patents, if any, have been leased, payment being made by a present lump sum. See contract, cancelled check, etc. If sizable, amortize on scientific basis, PROVIDED its useful life will continue throughout the term of the lease.
(l) "Obtain the correspondence files applicable to patents (these may be found filed under the name of the patent attorneys) and investigate to determine the status of the patents pending, patents not granted, patents granted, and leads to law suits which have been, or will be, started against the client for patent infringements."--F.W.K. Secure a certificate from the attorneys or the client summarizing the situation in respect to the patents.
See that all costs relating to "patents" not allowed by the auditor, are removed from the account.

(4) Copyrights.
(a) The cost of most copyrights should be entirely or largely absorbed by the income of the first edition. The legal life of a copyright is generally valueless as a basis for writing down the account.
(b) See the copyrights.
(c) The financial life history of each copyright must be kept separate on the audit papers. These latter must show the basis on which the cost is being written off, and the reasonableness of this basis as supported by current facts.
(d) In establishing amortization allowances distinguish between copyrights or transient works, such as tin pan alley sheet music, and on scientific works, such as a dictionary.

(5) Franchises.
(a) Do not capitalize annual payments. These are expenses.
(b) When a lump sum payment has been made at the beginning, see if it is feasible to amortize it scientifically.
(c) Examine the franchise. Abstract its important features. See if terms are being lived up to by all parties named therein. What is its length of life? What fees are unpaid? What liabilities exist?
(d) Amounts paid for definite pieces of condemned property must be charged to property (tangible) accounts. Damage costs may be capitalized in the franchise account.
(e) Same as #4-c above.
(f) If a franchise has been purchased, ascertain if it really is legally assignable. If so, see that these franchises are properly assigned to the client.
(g) Make certain that the account is being written off within the useful life of the franchise, as distinct from its legal life.

REVIEW QUESTIONS

1. What is the length of the legal life of a patent?
2. What is a copyright?
3. What is a franchise?
4. What is the length of the legal life of a franchise?
5. How would you set the value of a patent paid for with capital stock?
6. Is it necessary to abstract the provisions of a franchise? Expand your answer.
7. What is a trade-mark?
8. At what value should a client capitalize a patent which he has produced himself? Illustrate an incorrect method.
9. Periodic payments are to be made continually to a city in return for a franchise. How would you handle these payments?
10. Franchises are usually non-assignable. What meaning has that for the auditor?
11. Why should a trade-mark be registered?
12. Why is the actual life of most patents less than 17 years?
13. How would you determine the periodic value of a copyright?
14. What is the length of the legal life of a trade-mark?
15. During the life of a patent, a client has built up a tremendous good-
REVIEW QUESTIONS (Continuation)

15. (Cont.) will on that article. He desires to reestablish the value of the written-off patent account. It is to be labelled Goodwill. What is your position on this matter? Would it make any difference if the account was labelled Patents?

16. How would you amortize the Trade-marks account?

17. When may royalties paid on patents be capitalized?

18. May advertising expenditures be capitalized in the Trade-marks account? Elaborate your answer.

19. In order to balance up an issue of capital stock, the debit entry is put in an account captioned Patents. What is your position on this matter?

20. What is the length of the legal life of a copyright?

21. How would you determine the periodic value of a patent?

22. Do you agree with the answer given to the following question? If not, why not?

"Question:" A client for several years has pursued the policy of charging into operations all amounts spent for research, patents, etc., whether or not any benefit was derived from such expenditure. These expenditures have averaged approximately $200,000 a year for the past five years, during which the client has developed new processes and new products from which future profits will be derived. This research work is to be continued and in the course of time certain other products will be developed that will be of value. Should the cost of research be capitalized?

"Answer:" The practice of charging to expense all costs of current research work is not unusual; there is much to be said for it. If a special attempt is made to attain some definite, patentable improvement, it is permissible to carry forward the accumulating cost until results are known; if a valuable patent is secured, the cost of research leading up to it may be treated as part of the patent value, and written off over either the legal life of the patent or over its estimated useful life, whichever be the shorter period. When (as your question suggests) the company maintains, and expects always to maintain, a general research department its cost should be absorbed as general expense. If its cost were 'capitalized', future years might show a great accumulation of paper assets without value, for as new processes and new products appear older ones become valueless. This is especially true of the chemical industry.

In recent years the most progressive and enlightened companies in manufacturing business have leaned strongly toward the elimination from their accounts of indeterminable, intangible values; goodwill, trade-marks, patents, formulae, have been written down to a nominal sum, say one dollar. Upon the whole I think the practice of the client in this case is admirable."

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1 Journal of Accountancy, July 1930, p.69.
464. General Discussion.
   Familiar definitions state that goodwill is "the value attaching to the probability that old customers will continue to resort to the old place"; "that which adds value to a business by reason of situation, name, reputation, connection, introduction to old customers, and agreed absence from competition, or any of these things, and there may be others which do not occur to me."; is "the term -- in a balance sheet (which) represents the stated value attached to the business over and above the value of the other stated assets."; and is "the monetary value placed upon the connection and reputation of a mercantile or manufacturing concern, and discounts the value of the turnover of a business in consequence of the probabilities of the old customers continuing."

"When an individual, or a firm, or a corporation has gone on for an unbroken series of years conducting a particular business, and has been so scrupulous in fulfilling every obligation, so careful in maintaining the standard of the goods dealt in, so absolutely fair and honest in all business dealings that customers of the concern have become convinced that their experience in the future will be as satisfactory as it has been in the past, while such customers' good report of their own experience tends to bring new customers to the concern, there has been produced an element of value quite as important as -- in some cases, perhaps, far more important than -- the plant or machinery with which the business is carried on. That it is property is abundantly settled by authority, and, indeed, is not disputed. That in some cases it may be very valuable is manifest. The individual who has created it by years of hard work and fair business dealings usually experiences no difficulty in finding men willing to pay him for it if he be willing to sell it to them."

Dicksee says of goodwill: "It is obvious that no general definition of goodwill can be satisfactory. -- All that can be gathered -- is that where the locality of a business premises the trade, goodwill represents the advantage derived from the chance that customers will frequent the premises in which the business will be carried on; that where the business is one which depends upon the reputation of a firm, the goodwill consists of the advantage which the owner

1The following cases are interjected here. (1) "From the net profits for the three complete fiscal years preceding the death of the decedent, should be deducted 6% on the average net capital employed for the same period and a deduction of $100,000 for salaries of the two partners. The difference multiplied by 5 is the value of goodwill." -- re goodwill of Franklin Simon & Co.; (2) "In view of the length of time during which the business has been established its reputation, its advertising and its prominence in the dry goods trade, I think 5 years' average of annual net profits (for the last 6 years) is a reasonable value of the goodwill of the business." -- re goodwill of J.A. Hearn & Son.
derives from being allowed to represent himself as such; that where the value of the business is due to the individuality of the owner, and where its reputation cannot be separated from his, the goodwill is all but non-existent; and that where the value of the business depends on its business connections, the goodwill consists of the right to be properly introduced to those connections.

"All this tends to show that the exact nature of goodwill fluctuates with the class of business to which it refers, and that no general definition can be of any good, and it is better that it should be so. The absence of a hard and fast definition enables the court to take evidence and to determine the rights of the parties in accordance with the meaning given to the word goodwill by those who are in that class of business or profession in regard to which the litigation has arisen. . . . . . . .

The only necessary elements appear to be these; a positive element, enabling the person who acquires it to represent himself as the successor to the business of the person from whom he acquired it; and a negative element, entitling him to restrain the transferee of the goodwill from soliciting the old customers of the business which has been transferred."

In brief, goodwill is said to exist whenever the earning power of a business, trade or calling is larger or potentially larger than that of a new or "average" similar business, trade or calling in the same community. And, this goodwill arises from advantages in location, credit standing, reputation, ability, acquaintanceship, personality, name, customers' habit, efficient organization, trade-marks, consumers' and employees' satisfaction, and/or the like.

Dormant goodwill may be thought of as the goodwill; i.e., excess earning capacity, that would exist if the management were efficient, or if competition were eliminated, etc. That is, all of the necessary elements for goodwill are present yet for some controllable reason, not controlled, this success is not being achieved. Thus an entrepreneur, in effecting a merger or consolidation, may be very willing to pay much more for a business than its net tangible assets are worth, simply because he feels that he is able in one way or another (say through change of management, or by the elimination of competition) to increase its present earning capacity with, or without, some of the "materials" already present.

From what has been said, it should be clear that goodwill; i.e., excess earning power, arising from certain sources is more stable and valuable than that arising from other sources. Thus, if the goodwill of a client arises from the location of the business, it is more valuable if the premises are owned than if they are leased. Likewise, if the goodwill is due to the personality and ability of some one individual within the organization, the goodwill is less valuable since it is shorter lived than if, for example, it were due to a long established reputation for dealing only in quality merchandise.

Again, if the goodwill belongs personally to an auditor, lawyer, doctor, or the like, it is a type of goodwill that cannot be bought. That is to say, it is not the kind of goodwill which any one ought to buy, or can legally buy, because it is such a purely personal matter as to be non-transferable. Apart from the noted individual himself, his goodwill is non-existent. Moreover, for one to practice under the name of another in such a manner as to successfully induce the public to believe that he is the

The goodwill value attached to old and favorably known business names frequently has a great value, even though the profits in recent years would not justify any value. The buyer of such goodwill, however, looks toward the possibility of rejuvenating the old business and placing it on a profitable footing by the engaging of competent personnel, the introduction of improved methods, and relying upon the old name to carry on its traditions for attracting trade." A.C. Ernst, Printers' Ink, March 19, 1925.
other is doubtless a species of actionable fraud.

On the other hand, it is quite common for one business to buy out another business and still retain the name, and thus the goodwill, of the vendor business. There are many instances where the original owners, whose names are still the name of the business, have been dead for some time past.

Whenever a retiring partner sells out his entire interest in the partnership, including his share of the goodwill and the right to continue to use the firm name, he can not afterwards start in business under his own name, if he uses it in such a way as is calculated to deceive the public into believing that it is a continuation of the old business. It is also a certainty that this retiring partner can not successfully sue to have the new partnership drop his name from the name of the business. Of course, if the provisions of the sale do not distinctly provide for the continuing use of the old firm name, the remaining partners do not have the legal right to use the name of the retiring partner in the new firm name.

465. The Composition of the Account.—Undoubtedly, advertising is the most common and powerful method of building up goodwill. Thus, for example, every smoker knows that "Not a Cough in a Carload" stands for Old Gold cigarette. There can be no doubt but what the public became familiar with this slogan because of the very extensive advertising campaigns which "P.Lorillard" carried on. For this reason, the auditor often finds that the client has capitalized in the Goodwill account that portion of its advertising expenditures which it believes to be in excess of that required to maintain "normal" business. For a moment or two this procedure may appear to be sound, but its soundness will vanish the more one reflects on it. For example, it is open to all sorts of manipulation because no one knows or can know what amount of advertising is necessary for a particular business to maintain a "normal" volume of business. Moreover, what is a "normal" volume of business? However, it will be found advisable and proper to capitalize a conservative amount of the advertising expenditures, provided it represents that portion of the advertising costs truly applicable to the future. That is to say that there must be clear evidence that the benefits of the advertising will be reaped beyond the balance sheet date. The situation must not be one where it is HOPED and EXPECTED that the advertising will secure business in the future. There must be strong TANGIBLE evidence of that fact. Such an account should be called Deferred Advertising Expenditures. Its place on the balance sheet is distinctly under the main caption of OTHER ASSETS, rather than under PREPAID ASSETS. Moreover, this account must be entirely written off as rapidly as FACTS demand, usually a few months.

As had been just indicated, the bringing of goodwill on to the books in an arbitrary manner is not permissible. Unless this asset has been paid for in some way, its appearance on the balance sheet is barred. Just because a business has actual goodwill is no legitimate reason for bringing it on to the books. Moreover, the balance sheet value of the goodwill must never be regarded as an expression of its actual value.

Among the more usual transactions which may properly give rise to the birth of a goodwill account are: (1) the incorporation of a sole proprietorship; (2) the incorporation of a partnership, (3) the sale or purchase of a part interest in a sole proprietorship or of a partnership, and (4) the merging, consolidating, and reorganizing of corporations.

In regard to amortizing or writing off the goodwill account, the decided weight of opinion is that nothing needs to be done in this respect. Of

1The same procedure is apt to be found in respect to goodwill said to have arisen from patents. However plausible the situation may seem to be, it is a cardinal point of correct accounting procedure not to capitalize any of the cost of patents under the title of goodwill.

2It must always be remembered that a balance sheet can never give a complete picture.
course, the value of the goodwill does fluctuate from "year to year according to the state of trade - - - - - - - and to the reputation which the house has acquired or has lost for integrity, punctuality, solvency, and mercantile prudence. "But this is no legitimate reason for periodically revaluing the account.

In the first place, how ridiculous it would be to enter periodically the goodwill mark-up or mark-down (even if ascertainable) as an item in the profit and loss statement, when as a matter of actual fact no gain or loss whatever has been experienced since the asset has not been sold. As with other fixed assets, good accounting procedure does not consider the ups and downs of value in goodwill on the balance sheet or the profit and loss statement of a going concern,—neither is it required by law in the determination of profits available for dividends.

Moreover, is it possible to state with any definite assurance that the goodwill of the client is only thus and so? Obviously, the answer is,"No."

As goodwill is not a commodity that is dealt in, and as it is not susceptible to accurate measurement, there is no such thing as a unified market price for it. Suppose, for example, that the board of directors were to value goodwill at $5,000,000. What auditor (or any other person) is there who can assemble a case based on external stock market prices, current profits, or otherwise, proving that its true value beyond a shadow of a doubt is only $4,500,000? In brief, there is so much difference of opinion, even by qualified experts, about the true valuation of goodwill that by common consent it is usually allowed to remain at cost.

No harm can possibly be done by allowing this asset, goodwill, to remain at cost? No one of any experience whatever puts any faith in its valuation. The account is not and never has been above suspicion. "It is known the world over" that no reliance is to be placed on its face value. Everyone with experience, therefore, disregards the stated value of the goodwill and relies upon his own estimate of its value.

In computing goodwill the following formulae have been used.

(1) "Take the average net profits for a term of years, deduct interest on average tangible assets, less liabilities, employed; deduct the value (not necessarily the amount paid) of manager's (one or more) compensation; the balance represents the amount of profits which may be said to be attributable to goodwill. In fixing compensation for management, consider the class of business - stable or hazardous; general or special training, experience and ability required to conduct it; general standard of salaries in a similar business or in a business producing a similar amount of profit."

(2) "Whenever two or more enterprises combine, the goodwill of each may be established thus. Give to each business stock, preferred as to assets 1", - - - - - - - for it seems to me that auditors could never be in a position to accept full responsibility even to the extent implied by such a certificate (i.e. that the financial position of a company is at least as good as the balance sheet states) except with regard to floating assets and liabilities; they could not vouch for the value of goodwill and fixed assets or for the value or otherwise of forward commitments and other assets on liabilities in the broad sense which may have come to their knowledge in the course of "receiving information and explanations" and of examining books of the company which may not form part of the accounting system, but which may contain records affecting materially the true state of the company's affairs."

H.L. Hill, F.C.A.- "The Accountant" (Nov. 1923). Many of our "best" corporations, however, have written down their goodwill and/or intangibles to a nominal amount such as $1. When the amount of the write-off is disclosed, the practice is salutary, especially if the disclosure is maintained on each successive balance sheet. See sec. 468. However, if the goodwill was paid for on the basis of a number of year's excess earning power, etc., it is
and dividends to the extent of its appraised net assets. The rate of the preferred stock will be determined by the ratio of earnings to net assets of the "poorest" business, provided that ratio is below 7 or 8 per cent. (Thus, if K company has net assets of $100,000 and average annual earnings of only $6,000, the rate of the preferred stock will be set at not more than 6%). Issue common stock to the extent of the capitalized value of the excess of the contributed profits over the preferred stock dividends."

**EXAMPLE**

<table>
<thead>
<tr>
<th></th>
<th>A Co.</th>
<th>B Co.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appraised Net Assets, and, therefore, the Amount of Preferred Stock Issued to Each</td>
<td>$100,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Net Annual Profits for a Number of Past Years</td>
<td>$10,000</td>
<td>$7,500</td>
</tr>
<tr>
<td>Deduct - Preferred Dividends at 8%</td>
<td>$8,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>Excess of Contributed Profits Over the Preferred Stock Dividends</td>
<td>$2,000</td>
<td>$3,500</td>
</tr>
</tbody>
</table>

If these excess earnings are capitalized at 6%, A Co. will get $33,300 ($2,000 divided by .06) in common stock, and B Co. will get $58,300 ($3,500 divided by .06) in common stock. Thus the goodwill and the common stock of the new corporation will appear on the books at $91,600 ($33,300 plus $58,300).

3. "The difference between the prices at which an article is sold under the trade name and under no trade name, respectively, multiplied by the number of units sold during the year equals profits attributable to goodwill. Capitalize such annual profit on a 20 per cent basis."

4. "Multiply the average actual profits, determined by a careful analysis, by a multiplier from one to ten or more depending upon the period during which the excess profits will probably continue."

5. "Compare with businesses having similar sales and profits, when such companies have goodwill purchased for cash."

6. "Take the average Gross Income (i.e. Net Profits on Operations plus Other Income) for a number of years. Next, capitalize this figure at the rate of profit to be expected to be earned by this type of business. Deduct the liabilities from this answer, and the result is the maximum purchase price of the business. If this exceeds the networth of the business, the excess represents the maximum goodwill."

7. "To find what should be paid for the goodwill it would first be necessary to estimate the annual earnings. This may be done by averaging the earnings of several past years, or by any other rational means of estimate. This expected annual income is then capitalized at an agreed rate to determine what investment would yield the estimated income. The difference between this total investment and the net assets is accepted as the goodwill."

**ILLUSTRATION**

(Cont'd)

Annual average Profits for a Number of Past Years | $100,000

(Cont'd) undoubtedly correct to write the account off over these years on an annuity basis. I.E. tangible assets less liabilities. It is ordinarily inadvisable to issue a preferred stock bearing above 8%. At least 5 and usually not more than 10. The choice of a per cent is immaterial to A Co. or B Co.; but the lower the more conservative for all concerned. This assumes that Other Expense consists solely of financial expense.
(Solution)

# Capitalized Profits at 15% (100,000 divided by 15%)  3666.666.66
Net Assets (exclusive of any goodwill on the books)  628,329.19
Approximate Value of Goodwill (36,000)  38,337.40

(# 15% is the rate of earnings expected in this type of business.)

On analyzing the above 7 formulae, one should observe that there is generally some attempt to weave into each formula the net tangible assets, the normal rate of return to be expected in the particular type of business, and the future period during which the excess profits will probably continue. These are the three main factors to be taken into consideration.

Everyone admits that the future expected earnings is the principal factor in valuing the goodwill. For this reason the profits in the past are often analyzed minutely for whatever light they may shed on the subject for the present and for the future. Thus, for example, if the profits have been steadily declining from year to year, it is doubtful if any goodwill exists at all that is worth purchasing. But if the reverse condition is true, the steady increase in profits would forebode especially well for the future. Again, for example, an examination may reveal that the net profit figure has been computed without an allowance for the owner's salary. If so, this adjustment must certainly be made in estimating the profits attributable to goodwill.

Finally, it must be emphasized that time and again the amount paid for goodwill is the result of hunches or bargaining or other unscientific methods rather than by any formal computation such as those which have been indicated above (which is not to say these methods are all scientific). At most, these methods are MERELY attempts to value the goodwill under static conditions.

466. The Verification Procedure—Although the value of the intangible, goodwill, may be of equal or greater importance than the tangible assets, the auditor's duty in regard to it is chiefly confined to ascertaining the exact manner in which it got on to the books, and in fully commenting thereon in his report. If there is no report accompanying the balance sheet, the auditor's certificate must state the facts, or at least be qualified. The values so established need not concern the auditor.

In conclusion, if the goodwill is purchased for cash or stock as a part of the net assets of the vendor, or if it arises at the incorporation of a partnership, the auditor must seek confirmation of it in the directors' minutes. The values so established need not concern the auditor, except where fraud is clearly involved. This procedure is sanctioned by law, and by the difficulties of the problem. The auditor usually can not get at the facts with any precision, unless market values are available on the stocks given and unless an appraisal of the tangible property has been made. Even then there will be found to be perplexing problems such as that the identity of the vendor and vendee are practically the same persons. 1

1Thus the auditor may find that the company's excellent profits are due to a very favorable purchase of large quantities of raw material from a bankrupt concern, the like of which can not possibly happen again, except by sheerest luck. 2It must never be assumed that the excess of the par value of the securities given over the appraised value of the tangible property represents the goodwill for the purchaser may have gotten the property for less than what it is worth, or the securities may be worth more, or less, than par value. 3Of course, in many instances the auditor must definitely disallow the account.
467. The Balance Sheet Valuation.—Good accounting practice is followed if the Goodwill account is stated on the balance sheet at cost, irrespective of its wide variations in value from period to period. Therefore, by common consent the valuation of the goodwill is left to each interested party. However, it is common for very prosperous enterprises to write down this account, even to such a nominal sum as one dollar.

If any auditor, or anyone else, is not satisfied with this "laissez faire" procedure, let him try just once to ascertain and fix the value of the goodwill. His attempts, if adequately and properly carried on without preconceived ideas, and with an open mind, will be rebuffed. He will find that the opinions of qualified persons, such as entrepreneurs, actively engaged in purchasing businesses will vary widely, millions perhaps, as to the value of the goodwill of his client. Therefore, as has been stated, experience shows that any attempt to adjust the Goodwill account to a nicety is futile.

468. The Balance Sheet Presentation.—Where possible, goodwill should always be stated by itself. It may, however, be combined with patents and trademarks as an item under the main caption of INTANGIBLE ASSETS. Of course, separate ledger accounts will have to be kept for these several items because of their individual rates (if any) of amortization.

If the goodwill has been established arbitrarily at appraised values the balance sheet caption such as—Goodwill—(appraised value)—$2,000,000—must be clear on that point. The same requisite is urgent whenever the account has been written down substantially, thus: Goodwill—(cost $1,000,000)—$1. If the client objects to this procedure, its objection is all the more reason why the auditor should "stick to his guns". It is certainly strong evidence that the client holds this information to be important, and, therefore, it simply confirms the auditor's opinion.

The Federal Reserve Board showed the Goodwill account on its balance sheet as a deduction from the net worth. The idea is clearly that the goodwill must speak for itself via excellent profits, whereas ordinarily the client tries to speak for the goodwill. If the goodwill is actually there, various tests, such as the ratio of profits to the amount of assets employed, will reveal it. Clearly then, no harm is done to the client whenever a bank insists on adopting this treatment of goodwill.

469. See Plate 148.

4"But where the Goodwill represents that of a branch which has been closed down, for example, and the business of that branch has not been transferred to another branch of the same company, i.e., where it has in fact been lost, it is obvious that such capital lost must not appear in the accounts as still existing intact (as where it is included in the general heading "Goodwill" representing the sum total of the goodwill at various branches)" — Taylor & Perry, pg. 103.

2I.E. of a successful business, such as The General Electric Co. for example. Of course, in the case of a business with distinctly average or subaverage earnings and with poor future prospects, the problem of estimating the goodwill is NIL. In this connection the following presentation of the Intangible Capital Assets of The B.F. Goodrich Company on its 1926 consolidated balance sheet is of interest.

Intangible Capital Assets:

This Balance Sheet does not take into account the Capital Asset of Goodwill on the books amounting to $57,798,000.00, nor the Patents or Trade-marks, carried on the books at $1.00, but shows the condition of the Company on the basis of Tangible Capital Assets.

Whenever acquired it is often states as: "Goodwill Purchased — — $22,391,853.64" — National Dairy Products Corp. — 1932.
A SCHEDULE ON GOODWILL  PLATE 146

HOLT & HOLT, INC.

Goodwill

B/S Audit for Year Ending December 31, 1929

<table>
<thead>
<tr>
<th>Dr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>J 12 Balance at 12/31/29</td>
</tr>
</tbody>
</table>

Cash Paid to Holt & Holt (partnership) $50000.00 (check #1763)
1306 Sh. Capital Stock, Paid at par 130000.00 (SS) $180000.00

Assets of Holt & Holt (partnership) $262785.12 (R-1)
Liabilities 87643.94 175141.18

Excess, being the goodwill 4856.62

By vote of the Board of Directors 7/17/28 (page 187), "the values stated on the balance sheet of the partnership of Holt & Holt at June 30, 1928 are to be maintained, except that the difference between the networth of the partnership, and the cash and stock (at par) paid for it, is to be charged to Goodwill."

#From the June 30, 1928 balance sheet of Holt & Holt (partnership), certified by Price, Williams & Co.
See R-1.

The partnership was acquired on 7/8/28, per directors' minutes, page 185.

Fiscal year changed from July 6th to December 31 which is also the end of the client's business year.

469. Explanation and Comments.--In an instance of this sort, the decision of the Board of Directors is final. The auditor's duty is to see that the entries made by the client's accountant reflect the intentions of the directors as expressed in their minutes. Beyond this, the auditor is not required to go except to state definitely in his report how the goodwill arose.

(Although a balance sheet audit is AS OF THE CLOSE OF BUSINESS OF A SPECIFIC DAY, and NOT for a period of time, nevertheless, the above caption is not altogether absurd, since it means that the assets, as for example the plant properties, have not been audited ON THIS AUDIT for more than the current period.)
469a. Audit Program.

(1) Ascertain for your own information if the client's goodwill is evidenced by above average earnings. If they are above average, estimate (if possible) the goodwill for your own information.

(2) Ascertain from what source (location, efficient organization, connections of certain officers, etc.) the goodwill arises. Have a definite and intelligent opinion on and knowledge of all phases of the client's goodwill.

(3) Ascertain how the goodwill got on to the books. Is the entry justified by a bona fide TRANSACTION? If not, adjust the account or qualify the certificate. Disclose in the audit report all facts as to how the account arose and as to how the values were established.

(4) Ascertain if the client has capitalized as goodwill any portion of its advertising expenditures. Has the account been set up to cover a deficit? Reverse such entries.

(5) Do not regard the balance sheet value of the goodwill as an expression of its actual value. "As a balance sheet asset goodwill varies from the most profitable of all assets to a mere worthless space filler."

(6) Do not amortize the goodwill unless it represents the purchase price of a certain definite number of years' excess earning power, etc. Of course, if nonexistent, write the account off if the client will permit it.

(7) Examine directors' Minutes for any references to the establishment or write-down of goodwill.

(8) If the goodwill has been established arbitrarily by the directors at an appraised value, the balance sheet and audit report must state the facts. See that the credit arising therefrom is treated as capital surplus. (Really a valuation offset account). Use your influence to get the account removed, if "things" have not proceeded too far.

(9) When the goodwill is arbitrarily written down, such as to $1, the balance sheet should show the amount written-off. This information should be presented on future sheets. Amplify the balance sheet presentation by a full disclosure in the audit report.

(10) If the goodwill account has been set up to allow a stock dividend, examine directors' minutes for this action. Disclose the facts both on the balance sheet and more fully in the report. Investigate the legality of this issue.

(11) When payment for goodwill has been made in a form other than cash, ascertain (if possible) if the value assigned to it is reasonable. If it is unreasonable, endeavor to get the true values recorded, if you believe that there is a "ghost of a chance" of putting it across.

(12) "It is essential to separate tangible from intangible assets in any statement of financial condition. If a mixed aggregate of tangible and intangible assets be acquired for a single consideration, it is now considered unsound to state the joint value in a single figure."—F.W.T.

(13) Endeavor to educate the client into calling upon you for advice in all such matters as the establishment of goodwill AT THE TIME the matter is being considered. The auditor can often turn the directors' course of action into correct channels if the matter is influx. Once definite action has been taken, (especially if made public) the situation is then generally beyond the auditor's control, UNLESS fraudulent or otherwise illegal.
REVIEW QUESTIONS

1. Is it possible to buy the goodwill of a doctor who is retiring from practice? Why?
2. Is it possible to buy the goodwill of a grocer who is retiring from practice? Why?
3. May advertising expenditures be capitalized as goodwill? Why?
4. Is it permissible to arbitrarily set up goodwill and issue capital stock therefor?
5. Does the value of goodwill fluctuate?
6. What is dormant goodwill?
7. Should goodwill be gradually amortized? Why?
8. Give several formulae for estimating the value of goodwill. Illustrate with figures.
9. Give some of the various ways in which goodwill may be properly entered in the books of account. Give the accounting entries.
10. What is goodwill?
11. How did the Federal Reserve Board form of balance sheet show goodwill?
12. Comment fully on the following:

   Surplus at January 1, 1925
   \[ \text{\$75,334,930.57} \]
   Deduct- Unamortized Book Value of Power
   Leaseholds, Undeveloped Water Power,
   Patents, Trade-marks, etc., in excess of \$1.00
   \[ \text{\$29,423,509.20} \]
   \[ \text{\$45,911,421.37} \]

13. Mr. A.C. Ernst in Printers' Ink (March 19, 1925) says that "the purchase of goodwill is influenced in the price he pays for it by several very important considerations other than the past record of earnings, some of which I shall outline in the following:
   (1) "The possibility for the future in the general trade or industry; the trend toward a greater or lessening use of the product or service; and to what extent the business may be affected by varying economic conditions.
   (2) "The relative position of the business in its field when considered in the light of its importance in the trade; approximate percentage of output or volume of sales in relation to competitors; to what extent the business may be considered as a quasi monopoly.
   (3) "Advantages or disadvantages in the location of the business, particularly in relation to source of supply of material and labor and as a centre for distribution to the trade it serves.
   (4) "Possibilities for expansion in volume of business and profit with present plant capacity; more intensive cultivation of present avenues of trade and progressive selling methods.
   (5) "The effect on future profits due to expiring contracts for material and services at prices below present market and viewed in the light of recent trend in prices.
   (6) "The retention in the organization of important key men and capable departmental executives on a basis of compensation consistent with that paid by the present owner of the business.
   (7) "The economies that may be introduced, the application of better methods, the employment of expert service and the effect of such action in strengthening the organization and enlarging upon and safeguarding of profit.
   (8) "The normal rate of interest that capital can earn in other forms of conservative investment.

13. (Cont.)

(9) "The probable number of years that it will require to amortize the investment in Good Will, in connection with which should be considered the present value of an annuity payable over a period ranging anywhere from one to ten years.

(10) "Confidence in the ability of the purchaser to direct the business as successfully as the seller."

Name some other conditions not given by Mr. Ernst.

14. What is your opinion of the correctness of the procedure of Mr. J.I. Berry in arriving at the following goodwill.

"The stock of the Press Publishing Company and the Pulitzer Publishing Company has been valued by me by adding to the appraised value of the tangible property of each of these corporations a Good Will value consisting of the value of Associated Press memberships and all other elements of Goodwill arrived at on the following theory:

"By taking the average annual earnings of each of said corporations for four years preceding Mr. Pulitzer's death as a basis for capitalization; and in view of the fact that these corporations enjoyed, during the years for which the earnings are set forth, advantageous contracts for the purchase of white print paper at a figure far below the market value of such paper during those years, and the further fact that the contracts for the said paper were about to terminate within a few months subsequent to the death of the testator and that new contracts for such paper at the increased cost have been made before decedent's death, I have deducted from the average annual earnings 60 per cent of the difference between the market value of the said white print paper and its actual cost under the expiring contracts, because, while in my opinion these earnings were extraordinarily large by reason of these contracts, and an intending purchaser of the said newspapers would be confronted with this increased cost of white paper as affecting future earnings, nevertheless such a purchaser experienced in the management of a great daily publication would undoubtedly anticipate being able by practicing economies in other details of its administration to offset at least 40 per cent of this increased expenditure during future years.

"I have also deducted in addition thereto the value of the services rendered to each corporation by the testator, an extraordinary newspaper genius, whose services, in my opinion, were reasonably worth the sum of $100,000 a year to each corporation, and a further sum equal to 6 per cent on the capital invested."

| TABLE |
|---|---|
| PRESS PUBLISHING COMPANY (New York World) |

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average net earnings (four years prior to death less bonuses as indicated above)</td>
<td>$541,330.25</td>
</tr>
<tr>
<td>Sixty per cent of increase of cost of white paper</td>
<td>$210,000.00</td>
</tr>
<tr>
<td>Allowance for decedent's services</td>
<td>100,000.00</td>
</tr>
<tr>
<td>Six per cent on capital invested</td>
<td>121,550.00</td>
</tr>
<tr>
<td>Six per cent on valuation of Associated Press memberships</td>
<td>28,800.00</td>
</tr>
<tr>
<td>TOTAL DEDUCTIONS</td>
<td>460,150.00</td>
</tr>
</tbody>
</table>
REVIEW QUESTIONS (Continuation)

14. (Cont.)

Average net earnings less deductions as a basis for capitalization .......... $ 81,180.25
Good Will: $81,180.25 (Balance of net income capitalized at 10 per cent) .......... $ 811,802.25
Two Associated Press Memberships appraised at $240,000 each ................. 480,000.00
Appraised Value of assets over liabilities ................. 2,022,514.00
TOTAL VALUE ........................................... 3,314,316.25
Value of one share of stock ........................................... 662.66
Value of 4,990 shares held in the estate .......... $3,307,671.40

PULITZER PUBLISHING COMPANY (St. Louis Post-Dispatch)

Average net earnings, (four years prior to death) .......... $ 408,456.00
Deductions:
Sixty per cent of increase of cost of white paper .......... $ 54,600.00
Decedent's services .................................. 100,000.00
Sixty per cent, on capital invested, ($717,417.75) .......... 43,045.00
Six per cent on valuation of Associated Press Membership .......... 14,400.00

Average net earnings, less deductions .......... $ 196,411.00
Good Will: $196,411, (balance of net income capitalized at 10 per cent) .......... 1,964,110.00
One Associated Press Membership .................................. 240,000.00
Appraised value of assets over liabilities .......................... 717,417.75
TOTAL VALUE ........................................... 2,921,527.75
Value of one share ........................................... 292.15
Value of 9,164 shares held in the estate .......... $2,677,262.60
CHAPTER 30
THE VERIFICATION OF CONTINGENT ASSETS

470. General Discussion. --- Contingent Assets are assets which may possibly come into existence on the happening of some event or other. Thus, for example, there may be no record on the books of account — and properly so — of possible sums recoverable from lawsuits now in litigation, of bad debts charged off but not yet outlawed, or if outlawed or discharged in bankruptcy are now being made good, of overpaid taxes, of claims receivable for failure of a creditor to fulfill the terms of a contract, and of various other similar items.

In most instances, but in none of those mentioned above, contingent assets arise in connection with contingent liabilities. Thus the contingent liability on notes or acceptances receivable which have been discounted is accompanied by a contingent asset; i.e., a claim against the defaulter and/or prior endorser. However, it is to be noted that such a contingent liability may become a real liability, whereas the contingent asset may prove to be valueless.

Usually it is sufficient to enter the contingent asset as a footnote, or in short, on the balance sheet rather than in offsetting accounts. But some contingent assets, such as the notes receivable which have been discounted, are properly treated by entries in offsetting accounts. (In the writer's opinion, this is the best practice).

471. Discounted Notes and Acceptances Receivable. --- This is undoubtedly the most common type of contingent asset. If the maker of a discounted note receivable, or if the acceptor of a discounted acceptance fails to meet his obligation at maturity, the last endorser is called upon to make good on it. He in turn has a claim against the other prior endorsers, if any, and against the maker or acceptor, —as the case may be. Thus in the usual situation, assuming a single endorsement, the discounting bank, or other party, will call upon the client (the endorser) to take up the defaulted note or acceptance which he discounted at the bank sometime in the past. Whatever amount is paid to the bank for principal, interest, fees, etc. on the defaulted note or acceptance is chargeable to the maker (or acceptor). The client may charge the amount either to Defaulted Notes and Acceptances, or to Accounts Receivable — generally the latter. In either case, a reserve must be provided if the collection of the debt is doubtful, — which is most often the situation.

If the Notes and Acceptances Receivable Discounted account is credited at the time the instruments are discounted, the account should be deducted from the Notes and Acceptances Receivable account on the face of the balance sheet. Some bankers and auditors, however, prefer to show the notes gross, and the Notes and Acceptances Receivable Discounted account as a current liability. Such a presentation doubtless is correct from the banker's point of view, as it places the business in the most unfavorable light. If the current ratio can stand this test, the banker feels more
justified in making the loan requested.
If the Notes and Acceptances Receivable account is credited at the
time the instruments are discounted—which is usually the situation—,
the auditor will very probably show the discounted notes and acceptances
as a footnote on the balance sheet. Of course, if the client desires it,
either of the two other treatments of the situation can be easily given.

472. Federal Tax Refunds.—This is one of the most prolific sources of
contingent assets. As millions of dollars are actually refunded by the
federal government every year, this is a very real type of contingent
asset if the refund claim has any sort of "legs to stand on."
Although book entries may have been made in order to keep the client
posted as to the necessity of guarding against the statute of limitations
destroying the claim, nevertheless, they (the accounts) ought not to be
stated on the balance sheet. A footnote giving all of the facts is entirely
adequate, except in special cases as when the contingency is now a
certainty.

473. Discounted Accounts Receivable.—If accounts receivable are sold
with a guaranty as to their collection, the credit at the time of the sale
ought to be to Accounts Receivable Discounted,—not to Accounts Receivable.
As accounts receivable go bad much more frequently than do notes, the
Accounts Receivable Discounted account ought to be looked upon as a secured
liability account rather than as a valuation account to be deducted from
the Accounts Receivable account. That is to say, the vendor has not heard
the last of these accounts, even though he has sold them. Undoubtedly the
regarding of the Accounts Receivable Discounted Account as a liability ac-
count does not portray the legal situation. According to law, there has
been an actual sale subject to certain guarantees as to the client's making
good on bad debts arising therefrom. But the practical business aspect of
the situation is, to repeat, that a sum of money has been borrowed which
is secured by accounts receivable, plus a general guarantee.
If the Account Receivable account is erroneously credited at the time
of sale, the balance will be small. This will make it appear on the
balance sheet that the business is in excellent shape, because the infer-
ce is that the small balance is due to prompt collections. As this is
a gross misrepresentation of a major fact, the auditor must not permit
the accounts receivable account to be credited in his balance sheet pre-
sentation.†

474. Capital Stock Assessments.—In some few states auditors will
find that the state law provides for the assessing of a stockholder up to
a certain amount, say par value, on the happening of certain contingencies,
usually insolvency, bankruptcy, and the like.
If the business is in good shape, no mention of this contingent asset
will probably be made, but if the credit of the company is poor or flat,
a footnote on the balance sheet as to the amount of the possible assess-
ment should strengthen the credit position of the company. If the
assessment is to be made in the near future, or if it has already been
made, the situation may warrant its being embodied in the books of account
rather than as a footnote.

475. Life Insurance.—As we saw in the discussion of insurance, there
arises in most life insurance policies a cash surrender value after two or
three years. In a sense this is a contingent asset when viewed from the
periods prior to its origin.
†However, this is not yet the current practice of leading auditing firms.
Some auditors do not favor showing any value for it whatever until it actually comes into existence in the second or third year. That is to say, the premiums in the meantime are wholly expensed.

A second treatment recognizes the contingent asset each year by capitalizing out of the premium expense one-half of the cash surrender value which arises at the end of the second year. This is held by good authority to be a sound procedure, because there is only a very, very slight chance that the policy will be dropped before the end of the second year, provided the enterprise is a going concern. Moreover, if the insured dies during this period, the insurance benefit will greatly exceed the amount carried in the ledger account. The writer, however, does not favor this treatment.

476. Donated Land.—In some instances a donation of land, as by a city or town, may be contingent upon the prospective donee's performing certain things, such as, for example, employing for five years an average of 350 men per annum. In this specific case, the situation is best explained by a footnote on the balance sheet, and by an elaboration of it in the report, until the land is actually secured. But no objection, however, is found to the common practice of setting up the asset with a valuation reserve of equal amount against it. Again, the proposition may be stated on the balance sheet under Plant Property with the amount extended short. In the writer's opinion, it is futile and improper to debit the land account each year with one-fifth of the appraised value of the land on the assumption that one-fifth of it is earned each year. Here the contingency of getting the land is altogether too great to permit such precise treatment.

When/If title to the land is received at the end of the fifth year, the debit will be to land and the credit to Surplus—Donated Land, in the sum of the appraised value of the land.

477. Others' Property.—A few accountants and auditors hold that goods held on consignment, machinery held under a lease, and all similar property held in possession but owned by others ought to be shown on the balance sheet as contingent assets with the credits as contingent liabilities. This treatment seems to the writer to be an improper one because if the property is taken care of, insured, etc., the consignee or lessee will suffer no loss even though the property be destroyed. Moreover, there is no liability in the sense that money must be paid out to cancel any debt. The liability is usually simply one to protect the other's property in the manner that a prudent business man would do if the property were his own.

Again, most auditors do not favor showing these items on the balance sheet at all. In the writer's opinion this procedure is also faulty. Most or many of these items should be stated as footnotes, or preferably as items on the balance sheet in their proper classification, but extended short. How misinforming it would be to show machinery at $25,000 only, if there was $250,000 worth of additional leased machinery! The Plant Property on such a balance sheet would look lopsided, but a footnote or an item extended short would clear up the situation in a "jiffy".

478. Accommodation Endorsements.—If a bank refuses to discount the notes of a business because of its poor credit standing, the business may be able to get another business of excellent credit standing to endorse the notes as a favor, or in return for a fee. The second business simply puts its signature on the back of the notes and returns them to the first

1Obviously, this is not the correct proportion as any table of cash surrender values will show that the yearly increases are not equal in amount.

2The item should state: First Year's Proportion of Expected Cash Surrender Value.

3I.E. faulty in many instances,—such as the one cited.
company which then discounts the notes at the bank.

At maturity the bank will present the notes for payment to the first company, but should that company default on them, the second company, as endorser, will be held responsible. From this explanation it is clear that an accommodation endorsement may give rise to a real liability and to an asset (the note payable of the first company) of doubtful value. For this reason accommodation endorsements must never be given indiscriminately even for "old time sake". At most they should be strictly limited to such cases as where a parent company endorses the notes of a weak subsidiary, and the like.

Although some accountants do not make a record on the books of account of the accommodation endorsements which have been given, if any, their procedure leaves something to be desired. As the contingent liability often becomes real and as the asset is very often of doubtful value, a debit in the books to Accommodated Notes and a credit to Accommodation Endorsements is advisable. Such a record in these two accounts will tend to keep the situation ever before the management, and the auditor. Numerous businesses have become embarrassed as a result of having to make good on its accommodation endorsements.

In drawing up the balance sheet, the Accommodated Notes account is sometimes listed as a current asset and the Accommodation Endorsements account as a current liability. As the liability is only a contingent one, the writer does not favor this treatment of these two accounts. On the whole, a footnote on the balance sheet is the clearest and best method of stating this very important piece of information.

479. Other Items.—Other contingent assets may arise from law suits on patent infringements, from failure of others to fulfill the terms of their contracts, from guarantees made in respect to the principal and/or the interest on the bonds of another business (usually a subsidiary), and from similar situations. The treatment to be accorded these various items depends upon the particular circumstances. If the principles enunciated above have been grasped, there will be no unsurmountable difficulty in handling these situations properly.

ALWAYS secure a certificate covering the existence of these and other contingent assets, especially when accompanied by contingent liabilities.

479a. Audit Program.

(1) Distinguish between the contingent asset that arises in connection with a contingent liability, and the other type of contingent asset which comes into existence alone. In the former case do not forget to set up the contingent liability. When setting up the contingent asset (former case) ascertain to what extent it is good. Reduce to a sound value, if necessary.

(2) Enter the contingent asset either as a footnote, or in short, as seems seems best. When coupled with a contingent liability account, offset the contingent asset with the former valuation account. Do not place the contingent liability account among the equity accounts, UNLESS the contingency is practically (or dead) certain. In such instances consider also the necessity (as stated in #1 above) of writing down (or off) the contingent asset.

(3) Discounted Notes and Acceptances Receivable.

(a) Consider the advisability of getting the client to set up and USE a Notes Receivable—Discounted account.

(b) If the defaulter notes have been charged back to accounts receivable, separate them on aging the accounts receivable. Provide liberally for possible bad debts among them.

(c) See that the protest fees, etc. (if any) have been charged back to the defaulter (or prior endorser). The client should not absorb them as
expense.

(d) See if the client has been properly notified of the default according to binding legal procedure. If not, ascertain if the client still denies to stand the loss.

(e) Where prior endorsers exist, see that the client has legally notified them. Ascertain on the FIRST audit if the client understands the proper procedure to be taken in legally notifying endorsers of defaulted notes.

(f) When the statements are being prepared for a particular bank, ascertain from the bank if it regards discount notes simply as security for a loan. If so, set the contingent liability among the secured current liabilities, and show the discounted notes as a pledged asset.

(g) Always inquire concerning discounted notes whenever corresponding with anyone (who might possibly have some) concerning other matters.

(h) Accrued interest on discounted notes need not be set up as a contingent asset and a contingent liability.

(5) Federal Tax Refund.

(a) Make certain that the statute of limitations does not destroy the claims.

(b) A footnote giving all of the facts is the best procedure, except in special cases as when the contingency is now a certainty.

(5) Discounted Accounts Receivable.

(a) Ascertain the advisability of regarding this transaction merely as a loan secured by the pledging of accounts. If so, set up the loan as a secured current liability.

(b) Review the accounts for bad debts. Set up an adequate allowance.

(c) Read the contract. See that the accounting entries are correctly in accordance therewith. See if all provisions of the contract are being fulfilled both parties to it. Are additional accounting entries necessary?

(d) In passing on the credit standing of the client, do not fall into the mistake of regarding the small balance of accounts as due to collections.

(6) Capital Stock Assessments (See text).

(7) Life Insurance (See text).

(6) Donated Land (See text).

(9) Others' Property (See Text).

(10) Accommodation Endorsements.

(a) This liability is not to be undertaken lightly when done merely for "acquaintance sake". Such endorsements become real liabilities time without number. When given by a parent for a subsidiary, or by one subsidiary for another, it is usually fully justified.

(b) ALWAYS give ALL of the facts on the balance sheet, preferably as a footnote. They are IMPORTANT information.

(c) Secure a certificate covering the existence of this and other contingent assets, especially when accompanied by contingent liabilities.

(d) If the contingency appears to be a real liability, do not hesitate to set it up as such. Also, ascertain the true worth of the asset.

REVIEW QUESTIONS

1. Name three contingent assets which arise from contingent liabilities.
2. Outline four methods of dealing with notes receivable discounted on the balance sheet.
3. How should land which is to be received gratis, when certain stipulations have been fulfilled, be handled in the books of account?
4. How should others' property be shown on the balance sheet?
5. Discuss very fully the topic of Accommodation Endorsements.
6. How would you show on the balance sheet a claim for a federal tax refund?
7. Name three contingent assets which have no accompanying contingent liability.
8. When may capital stock assessments become contingent assets?
CHAPTER 31

LIABILITIES

480. General Discussion.

481. Explanation of Plate 149.

PLATE 149 - Auditors' Certificate Qualified as to Federal Taxes.

482. Explanation of Plate 150.

PLATE 150 - A Form of Client's Certificate on Liabilities.

483. Explanation of Plate 151.

PLATE 151 - Two English Certificates.

484. The Arrangement.

485. Explanation of Plate 152.

PLATE 152 - The Presentation of Liabilities per Federal Reserve Board Balance Sheet.

486. Offsetting Liabilities Against Assets.

487. Adjustments.


489. Fixed Liabilities.

490. Comments on Balance Sheet Presentation.

491. Explanation of Plate 153.

PLATE 153 - A Presentation of the Equities when the Assets are From Fixed to Current (1st type).

492. Explanation of Plate 154.

PLATE 154 - A Presentation of the Equities When the Assets are From Fixed to Current (2nd type).

493. Rules for Proper Financing.

493a. Review Questions.

Review Questions.

490. General Discussion. — Speaking in broad terms and somewhat loosely, it may be said that the auditor need scarcely "worry" that he will overlook any important assets belonging to the business. That is to say, the business itself can be relied upon to see to it that all of its property is recorded in the books of account. On the other hand, it should be obvious that the auditor can not proceed on this basis in his audit of the liabilities. In fact, in a balance sheet audit there is scarcely anything of equal importance to that of ascertaining whether or not all the liabilities of the client have been taken up. Briefly stated, the auditor's duty is this: (1) he must make certain that all liabilities are on the books; (2) he must satisfy himself that all the stated liabilities are real liabilities; (3) he must see that all liabilities were properly incurred; (4) he must see that all liabilities are properly valued; and (5) he must see that all liabilities are properly presented on the balance sheet.

The element of opinion, which is of prime importance in the proper valuing of assets, fades into comparative insignificance in the case of most liabilities. Thus, for example, in the case of plant assets the rate of depreciation to be applied to the machinery buildings, and equipment is a matter of opinion. So also the amount of the Allowance for Bad Debts.

1This is not always true; e.g., in some cases of fraud the assets are gradually understated or omitted so that they may be stolen; sometimes the assets are knowingly understated by "those in power" in an effort to force stockholders to sell out for "a song"; and sometimes the policy of the directors is to create and increase a secret reserve (the Lord Kylsant case). "This also is not always true, for, "if a plan is on foot to have certain interests in the business sell out, liabilities may purposely be inflated."
represents an opinion as to the value of the notes and accounts receivable rather than a fact. To be sure, expert opinion is required in every instance, but it is opinion nevertheless. On the other hand, if a bond issue is outstanding for $3,000,000.00, the liability thereon is determined. There is ordinarily no call for evaluating this liability; there is no need for an expression of expert opinion. But it should be noted that there are times when the amount of important liabilities is merely an expression of opinion. The most prominent example of this was in the case of federal income taxes during the period when rates were based on invested capital. Practically every auditor’s certificate qualified the auditor’s responsibility in regard to the amount of this liability (Plate 149). by way of explaining item 2 in the first paragraph above, it may be pointed out that on some occasions it is literally true that clients will show as liabilities items which are really a part of networth. Thus in partnerships, partners’ loan accounts are often classified by the client as liabilities when as a matter of fact they are a part of the proprietorship equity. From the point of view of creditors, these accounts are just as much security to them as are the capital accounts. In brief, partners’ loan accounts are simply records for keeping track of certain networth sums to which the partners have given certain preferences over other networth sums called partners’ capital.

As stated in item 3 above, the auditor must satisfy himself that all liabilities were properly incurred. Thus, for example, the auditor should see that the business received value for each note payable issued or outstanding. If it did not receive value, the business may not be liable on the note, but have a claim against the one who got the proceeds of the note.

Item 5 cannot be overemphasized. The problem of the properly describing and placing liabilities on the balance sheet is of paramount importance. It is never sufficient merely to show the liabilities at their true amount. Thus, a certain liability on notes payable—banks is an altogether different liability from those for an equal sum which have as security a chattel mortgage on machinery. Likewise, the proper classification of liabilities into current, deferred, and fixed groups presents an altogether different balance sheet from an unclassified, or an improperly classified, balance sheet.

Certain prominent national auditing firms make it a practice to secure from each client a certificate to the effect that all liabilities have been recorded in the books of account (Plate 150). At first glance this procedure appears to be “passing the buck” on the verification of liabilities from the auditor to the client. A novice might indeed be tempted to ask, “What kind of an auditing firm is it which does not dare rely on its own auditing to reveal all of the liabilities?”

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1 The common exception is when the liability is payable in the money of another country at a time when exchange rates are fluctuating widely.
2 Even in current times (1931) “the Government is making refunds every year to the average amount of $6,000,000.00 monthly.”
3 This is especially true of certain Reserves which are true surplus, or which are overstated liabilities, or which are asset valuation accounts (possibly overstated). These are designated as liabilities by the officers for some ulterior personal motive.
4 However, the writer favors showing partners loan accounts among the current liabilities if they are to be paid off within one year; but if the clients desire it, he would not hesitate to show the loans separately in the networth section, provided they are to remain as loans.
5 Thus the liability arising from an ultra vires or other illegal act may be the legal liability of the directors, and not of the corporation.
The answer to this query is perhaps best introduced by the following quotation taken from the English Companies Consolidation Act of 1908, Section 113 (2).

"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—-

" (Plate 151).

From a reading of these sections of the above act, it is obvious that the officials of a company, as well as the books of account, must be examined in a properly conducted audit. The truth of this assumption should be self-evident. There are often many important facts affecting the financial condition of a company which can be recorded in the ledger. Likewise, there are often many entries in the books of account which cannot be adequately explained except by the officials themselves. Moreover, what auditor is there who does not want or need to know whether his client is co-operating with him, or fighting against him (by purposely withholding facts), in his effort to present a proper picture of company's affairs. Therefore, just as the facts ascertained from an examination of the accounts are written down, so also the facts ascertained from the officials are likewise written, and signed by them as a measure of protection for the auditor.

461. See Plate 149.

462. See Plate 150.

463. See Plate 151.

464. The Arrangement—This section is to be devoted to a reiteration and development of the statement that the importance of the arrangement,

The entire success of an audit depends upon the intelligence and thoroughness with which the vouching is done. Vouching does not seem to comprehend merely the inspection of receipts, say, in connection with the Cash Book; it should include the scrutiny of every transaction of the business plus evidence, either documentary or otherwise, of sufficient validity to satisfy the auditor that each such transaction is in order, has been authorized properly, and is recorded correctly. This type of vouching requires the auditor to go behind the books and trace the entries back to their source. Only by so doing, is it possible to determine the complete meaning under the circumstances of the transactions encountered; if an auditor concerns himself only with the entries as they appear in the books, his deductions mostly will be incomplete with the result that many matters of importance affecting the accounts materially will be passed as correct in error. Book entries reflect only such information as the bookkeeper desires to have displayed; hence, such information may be contrary to fact, purposely or otherwise. Only external evidence can give the auditor a correct idea of the true state of affairs; hence, thorough and efficient vouching represents the very backbone of auditing."—Bennett (p.68)

In the writer's opinion, there is no one thing which is more detrimental to fostering the public's demand for published certified statements than is the present day hodge-podge presentation of the equity side of the balance sheet.
(a) Auditors' Certificate

"We have audited ______ and hereby certify that, in our opinion, the above Balance Sheet correctly reflects the financial condition of the Company at April 30, 1920, subject to the liability for Federal Income and Profits Taxes accrued at that date."

(b) Auditors' Certificate

General Motors Corporation,
Broadway at 57th Street,
New York, N.Y.

"We have ______ at December 31, 1927 ______ reports.
"We have verified the provision for your Federal income tax liability for the year 1927, but have made no study of the existing situation with respect to tax adjustments applicable to prior years inasmuch as you have a special department to handle such tax matters.
"We have not examined the minutes of your governing bodies.
"We Hereby Certify ______ correct.

New York, February 16, 1928.

(Signed) HASKINS & SELLS"

(c) Auditors' Certificate

Chicago, Illinois
February 23, 1921

"We Hereby Certify ______ Albert Pick & Company, Chicago, and Albert Pick & Company, Bridgeport, Inc., Bridgeport, Conn. for the year ended January 31, 1921 ______. The Provision for Federal Income and Excess Profit Taxes is in accordance with the books and is subject to adjustment upon final determination of the liability therefor ______.

ERNST & ERNST
Certified Public Accountants"

(d) Auditors' Certificate

"______ As far as we could determine, all direct and contingent liabilities are properly stated in the annexed Balance Sheet, with the exception of the provision for Federal Taxes. This latter, as usual, is subject to adjustment by the Treasury Department upon its examination of the company's returns, _________."

481. Explanation and Comments.--As stated in the text, the element of opinion is not nearly so important in the valuation of liabilities as in the case of assets. However, as shown by these qualified certificates, there are very important instances where opinion, albeit expert opinion, is required to establish the amount of the liability.

In the case of the United States Rubber Company, the federal tax qualification was stated on the face of its 1928 Consolidated General Balance Sheet as follows:

Surplus (subject to final determination of Federal taxes for years subsequent to 1917) 18,006,640.08
A FORM OF CLIENT'S CERTIFICATE ON LIABILITIES  PLATE 150

CLIENT'S CERTIFICATE

We hereby certify, (1) that we have made every effort to get in all vouchers covering materials received, expenses incurred, etc. prior to the close of business on June 30, 1930, and, to the best of our knowledge and belief provision has been made on the financial records for these and all other liabilities of the Corporation at said date with the exception of vouchers aggregating $12,000.00 covering merchandise in transit, no part of which has been included in the inventory or charged to our trade at said date; (2) that except as herein below noted, the Corporation was not liable at said date as endorser or guarantor on any accommodation paper, contract or agreement whatsoever; had no outstanding contracts of a speculative nature for material or other items; had no damage or law suits or judgments pending against it; or was not otherwise contingently liable on account of discounted notes, trade acceptances or other form of obligation.

Discounted Notes and Acceptances $35,147.16.

Pawtucket, Rhode Island
July 17, 1930

The Jordan Merrill Company
By _C.Merrill___ ___ ___ __
Treas.

By _R.E.Jordan___ ___ ___ __
Pres.

462. Explanation and Comments.—It is not unusual for some of our leading auditing firms to secure from each client a certificate similar to the one shown in this plate. At first glance, this procedure appears to be "passing the buck" on liabilities from the auditor to the client, but as explained in the text, the officials, as well as the books and records, must be examined in a properly conducted audit. Naturally, the results of the interview with the officials are written down, and as a means of protection to the auditor, and of preventing misunderstandings as to what was said, their signature thereto is secured.
(a) AUDITORS' CERTIFICATE

"We have examined ______ according to the best of our information and the explanations given to us and as shown by the Books of the Company.

"We have received all the information and explanations we have required."

(b) AUDITORS' CERTIFICATE

"In accordance with the provisions of Section 113, Subsection 2, of the Companies (consolidation) Act, 1908, we beg to report that we have obtained all the information and explanations we have required, and that in our opinion the above Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs, according to the best of our information and the explanations given to us, and as shown by the books of the Company."

483. Explanation and Comments.—These two certificates are given to show that certain English certificates are carefully worded to conform to the provisions of the Companies Consolidation Act of 1908 (section 480).
nomenclature, form, and grouping of liabilities cannot be exaggerated.

Obviously, the arrangement of the liabilities should follow that of the assets; i.e., if the order of the assets is from current to fixed, that of the liabilities should also be the same. This co-ordination of asset and liability grouping is required so that a comparison of the current assets and the current liabilities may be readily drawn, for it is the current assets to which current creditors must look for the prompt liquidation of their claims. Likewise, under this plan the fixed assets may be easily compared with the fixed liabilities and the capital out of which they are financed.

If possible, the arrangement of the items within each group should be made on the basis of their respective due dates. In most cases, however the full adoption of this plan is wholly impractical.

For internal and credit purposes the proper arrangement and presentation of liabilities is suggested and indicated by the balance sheet of the Federal Reserve Board (Plate 152). For public use, however, such detailed balance sheets are often unnecessary and too private. In such instances a less detailed presentation is often permissible. (See however question 20).

485. See Plate 152.

486. Offsetting Liabilities Against Assets.--- It is a cardinal principal in all balance sheet presentations that liabilities must never be cancelled against assets. Thus, to illustrate, it is incorrect and thoroughly deceptive to show merely one's equity in a piece of property when said property is owned but subject to a mortgage. Both the value of the property and the amount of the mortgage are important facts.

487. Adjustments.---Before closing the books of account it is necessary to take an inventory of all unrecorded liabilities. These adjustments are comprehended by such groups as accrued expenses, deferred income, accounts payable, etc.

Accrued expenses are those expenses which have been incurred, but for which no invoice has been received because it is not time for the creditor to present his bill (if any). The ascertaining of all of these accruals calls for considerable ingenuity, skill, work, and judgment on the part of the auditor. A review of the nature of the balance sheet and profit and loss items will often suggest possible accrued expenses. Thus notes payable immediately suggest accrued interest payable, and wage expense suggests possible accrued wages payable. Obviously, it is always extremely helpful to refer to the working papers for the accruals which were necessary on prior audits.

Despite the carefulness with which an auditor may conduct this phase of his audit, it is very easy for him to omit some accruals, unless he has a very intimate knowledge of the business under audit and of trade and general business practices and customs, and unless the client keeps a detailed record of all services being received.

Although deferred expenses are assets and not liabilities, an adjustment to this type of account may arise out of a consideration of certain liabilities such as notes payable-banks. When a note payable is discounted at a bank, the discount is deducted at once from the gross proceeds of the note. Thus it comes about that the interest on notes payable-banks is generally paid in advance. For this reason it is necessary to defer the prepaid interest on those notes payable-banks which are outstanding at the audit date. The same sort of adjustment is required in the case of notes payable given to creditors when said notes have the interest included in their face.

1See Appendix C, Sec. 12-#4.
Notes and accounts payable:

Secured liabilities—

Obligations secured by—

Customers' accounts assigned, to the amount

Liens on inventories

Securities deposited as collateral

Other collateral

Unsecured notes—

Acceptances made for merchandise or raw material purchases

Notes given for merchandise or raw material purchased

Notes given to banks for money borrowed

Notes sold through brokers

Notes given for machinery, additions to plant, etc.

Notes due to stockholders, officers or employees

Unsecured accounts—

Accounts payable for purchases (not yet due)

Accounts payable for purchases (past due)

Accounts payable to stockholders, officers, or employees

Accrued liabilities (interest, taxes, wages, etc.)

Other current liabilities (describe fully)

Total current liabilities

Fixed liabilities:

Obligations secured by—

Mortgage on plant (due date)

Mortgage on other real estate (due date)

Chattel mortgage on machinery or equipment (due date)

Other funded indebtedness (describe fully)

Total liabilities

485. Explanation and Comments.—This plate is indicative of the proper type of balance sheet presentation of liabilities when the balance sheet is for internal or credit purposes.
Deferred Income is income which has been received but not earned. This type of liability should be placed on the balance sheet immediately after current liabilities. It is not a current liability because it is not payable in cash, except on rare occasions. Thus deferred rent income will not be paid off with cash but with services. If, however, the rental property should be destroyed and not be rebuilt for some time, the deferred rent income would become a real current liability payable in cash. In some instances it is advisable to show the long term deferred income separate from the short term deferred income.

488. Current Liabilities.—Although it is not feasible to limit the term current to any definite period of time, it may be said that debts with a maturity of one year beyond the date of the balance sheet mark the extreme outer boundaries of current liabilities. Moreover, current liabilities must be limited to those which are to be settled out of current assets; hence a maturing bond issue, which is to be refunded, is not a current liability under ordinary circumstances.

Notes to banks and brokers, accruals, trade-accounts, trade-notes, acceptances, and declared dividends constitute the more common current liabilities. At times, however, installments on serial issues of bonds and mortgages are properly included therein. Likewise, deposits which are subject to withdrawal in the near future are current debts. Finally, if prepaid assets are considered to be current assets, deferred income must be treated as a current liability.

From what has been said, it should be obvious that temporary loans should be made for temporary financing only. No one realizes this fact more than the experienced banker and the credit houses, except perhaps the business man who has gotten into a sorry mess by borrowing on short terms, sums which he has invested in plant properties. One of the major functions of a commercial bank is, of course, to loan money for 60 to 90 days to finance sound businesses which are in the midst of their seasonal peak loads, for at such a time operating expenses are very heavy and the accounts receivable are swollen from the large volume of credit sales. Soon, however, the call for cash to meet expenses will slacken and at the same time the accounts receivable will be in process of collection. Thus, if the financial program of the business has been properly budgeted, the cash with which to liquidate these loans will be on hand within the aforesaid 60 to 90 days.

489. Fixed Liabilities.—Fixed liabilities are those debts which mature more than one year after the date of the balance sheet. The most common types of fixed liabilities are bonds, notes, and mortgages. These debts are generally incurred to secure additional fixed capital beyond that contributed by the stockholders through capital stock and surplus. Thus long term debts are proper in financing extensions of plant property, in providing additional working capital, in refunding maturing long term obligations, in purchasing the controlling interest in the stock of a much needed affiliated company, and so on.

490. Comments on Balance Sheet Presentation.1—The main heading of the right hand side of the account form of balance sheet should be LIABILITIES AND CAPITAL. In the writer's opinion this is not a mere academic matter. It is a thing of considerable import to the vast majority of the general public to which every auditor owes a duty. Of course, if a client prefers the single caption, LIABILITIES, that settles the matter immediately, for

1A TRUE contingency reserve should be placed between the total liabilities and the capital.
the balance sheet (even though certified) then becomes the client's and not
the auditor's. (See however question 21).

Likewise, in the writer's opinion, it is incumbent upon the auditor to
designate the TOTAL LIABILITIES. Unless a balance sheet is sharply divided
into liabilities, true contingency reserves, and capital, it is largely
worthless. For this reason there should not be any main group entitled
RESERVES, unless they are all TRUE contingency reserves. All reserves
should be classified as liabilities, as surplus, and/or as deductions from
assets according to their nature. If the reserves are not so treated, an
analyst should give himself (not the company) the benefit of the doubt by
regarding them as valuation allowances or as liabilities.

When the order of the assets is from fixed to current, the order of
the liabilities and capital is generally given as follows: either, capital
stock, long term debts, current liabilities, deferred credits, and surplus
(Plate 153), or, long term debt, current liabilities, deferred credits,
capital stock and surplus (Plate 154). The latter form is preferable.

491. See Plate 153.

492. See Plate 154.

493. Rules for Proper Financing.—As the auditor who can make practi-
cational constructive suggestions is in demand when others are slack, the fol-
lowing rules for proper financing may be helpful to the auditor in checking
up on the client's financial policies.

1 All cash discounts should be taken even if it necessitates borrow-
ing.

2 Short term loans are advisable for temporary needs only.

3 If a long term debt is not going to be refunded, provision should
be made for its gradual reduction.

4 The maturity of a debt should not exceed the life of the asset
which it finances.

5 Borrowing occasionally when it is not necessary will often prove
helpful in securing loans in hard times or crises. Moreover, the interest
rate is apt to be lower than would otherwise be the case. (That is, there
has been built up an introduction to the bank plus a record for prompt
payment of debts.)

6 Borrowed money should produce its own hire plus a profit.

7 Money should not be borrowed to speculate on purchase commitments,
etc.

8 Trade acceptances payable are preferable to accounts payable in
that they permit the taking of discounts. They may also serve as an effec-
tive check on piling up inventories because of high pressure salesmanship
and/or extremely favorable credit terms of the "dollar down—catch me if
you want the rest" type.

493a. Audit Program.

1 Except, perhaps, if the bond market is unfavorable.

1 (1) The auditor's duty is: (a) to make certain that all liabilities
are on the books; (b) to satisfy himself that all of the stated liabilities
are real liabilities; (c) to see that all liabilities were properly in-
curred; (d) to see that all liabilities are properly valued; (e) and to see
that all liabilities are properly described and placed upon the balance
sheet.

(2) ALWAYS secure a certificate from the client to the effect that all
liabilities have been recorded.
PLATE 153
A PRESENTATION OF THE EQUITIES WHEN THE ASSETS ARE FROM FIXED TO CURRENT
(1st type)

LIABILITIES AND CAPITAL

CAPITAL STOCK:
- Preferred Stock (6% cumulative-auth. 3,000 sh. Par $100) Outstanding 2,000 shares $200,000.00
- Common Stock (Auth. and Outstanding 10,000 sh. Par $100) Total 1,000,000.00
  Total $1,200,000.00

FIRST MORTGAGE BONDS (6%, due 1945)
Authorized, Issued, and Outstanding 500,000.00

CURRENT LIABILITIES
- Notes Payable-Brokers $100,000.00
- Trade Acceptances Payable 67,461.93
- Accounts Payable-Trade 31,709.10
- Accrued Payables, etc. 15,648.24 214,839.27

DEFERRED INCOME
RESERVES
SURPLUS:
- Balance, January 1 $89,642.54
- Profit (Exhibit B) Total 267,949.75
  Less-Dividends 357,492.29 56,000.00
  Total 301,492.29

TOTAL LIABILITIES AND CAPITAL $2,228,330.30

491. Explanation and Comments.—This type of presentation is for the purpose of showing the extent to which the fixed assets are financed by the capital stock and the long-term debt. If the sum of these two equities exceeds the sum of the fixed assets, the arrangement is fairly satisfactory. On the other hand, if these equities are less than the fixed assets, the surplus should also be placed at the top,—but it never is. Moreover, there is NO clear cut segregation of the liabilities and the capital.

Although common, this arrangement of the liabilities and capital is NOT recommended.

Note that the nature of the RESERVES is NOT disclosed. Although this is a common practice, it is reprehensible.

The words et cetera (etc.) are looked upon with suspicion by bankers and credit men because they often cover a "multitude of sins". Accordingly, the expression should never be used. If the omitted items are of the same nature as those specified, no harm is done in not mentioning them by the words et cetera. On the other hand, if the omitted items are not of the same category as those named, they MUST be disclosed in detail.
A PRESENTATION OF THE EQUITIES WHEN THE ASSETS ARE FROM FIXED TO CURRENT (2d type)

LIABILITIES AND CAPITAL

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Long-term Debt:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Five Per Cent First Mortgage Sinking Fund Bonds</td>
<td>Due January 1, 1935—Auth. $1,000,000</td>
<td>Is issued 1,000,000.00</td>
</tr>
<tr>
<td>Less - In Sinking Fund</td>
<td></td>
<td>40,000.00 $960,000.00</td>
</tr>
<tr>
<td>Six Per Cent Debenture Bonds</td>
<td>Due July 1, 1940 - Auth. $500,000</td>
<td></td>
</tr>
<tr>
<td>Issued and Outstanding</td>
<td></td>
<td>500,000.00 $1,460,000.00</td>
</tr>
<tr>
<td><strong>Long-term Deferred Income on Service Contracts</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current Liabilities:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notes Payable—Banks</td>
<td>$300,000.00</td>
<td></td>
</tr>
<tr>
<td>Accounts Payable—Trade</td>
<td>147,612.94</td>
<td></td>
</tr>
<tr>
<td>Dividend Payable—Preferred Stock</td>
<td>35,000.00</td>
<td></td>
</tr>
<tr>
<td>Due January 15, 1930</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued Payables, including interest, wages and taxes</td>
<td>81,096.47</td>
<td>563,709.41</td>
</tr>
<tr>
<td><strong>Total Current Liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current Deferred Income</strong></td>
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<td></td>
</tr>
<tr>
<td>TOTAL LIABILITIES</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$2,060,177.35</td>
<td></td>
</tr>
<tr>
<td>Contingency Reserve for Lawsuit Pending</td>
<td>100,000.00</td>
<td></td>
</tr>
<tr>
<td><strong>Capital</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Stock:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Seven Per Cent Preferred (Auth. 15,000 sh., Par $100)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fully Paid and Issued - 10,000 shares</td>
<td>$1,000,000.00</td>
<td></td>
</tr>
<tr>
<td>Common (Auth. 30,000 sh., Par $100)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fully Paid and Issued - 30,000 shares</td>
<td>2,000,000.00</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$4,000,000.00</td>
<td></td>
</tr>
<tr>
<td>Surplus:</td>
<td>$456,860.42</td>
<td></td>
</tr>
<tr>
<td>Earned Surplus</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserve for Sinking Fund</td>
<td>648,096.37</td>
<td></td>
</tr>
<tr>
<td>Capital Surplus</td>
<td></td>
<td>$1,149,956.79</td>
</tr>
<tr>
<td><strong>TOTAL LIABILITIES AND CAPITAL</strong></td>
<td>$7,230,134.14</td>
<td></td>
</tr>
</tbody>
</table>

492. **Explanation and Comments.**—An arrangement of the equities (liabilities and capital) in this manner permits the reader of the balance sheet to ascertain readily the extent to which the real property has been mortgaged. Moreover, the liabilities and the capital are sharply differentiated. Such a presentation is very desirable, especially if the statement is for general publication.

I repeat, there is no one thing which is more detrimental to fostering the public's demand for published certified statements than is the present day hodge-podge presentation of the equity side of the balance sheet.
(3) The auditor must keep clearly in mind that the officials of a company, as well as the books of account, must be examined in a properly conducted audit.

(4) The importance of the arrangement, nomenclature, for and grouping of liabilities can not be exaggerated. See balance sheet of the Federal Reserve Board (plate 152).

(5) The offsetting of liabilities against assets is pure deception.

(6) Always review both balance sheet and profit and loss items for suggestions as to possible accruals, etc.

(7) Refer to the working papers for the accruals which were necessary on prior audits, especially those at corresponding dates.

(8) Review such profit and loss accounts as interest expense, tying each entry to specific liabilities.

(9) Set up current deferred income items in a separate group directly after the current liabilities.

(10) Although it is not feasible to limit the term current to any definite period of time, it may be said that debts with a maturity of one year beyond the date of the balance sheet mark the extreme outer boundaries of current liabilities. Moreover, current liabilities must be limited to those which are to be settled out of current assets.

(11) If prepaid assets are considered to be current liabilities, deferred income must be treated as a current liability.

(12) Current maturities of long term debts are current liabilities if payable out of current funds.

(13) Ascertain if the client is observing the rules for proper financing (section 493). If not, make corrective suggestions.

(14) When permitted to do so, head the balance sheet either LIABILITIES and CAPITAL, not simply LIABILITIES.

(15) It is incumbent upon the auditor to designate the TOTAL LIABILITIES. In the writer's opinion this is a PARAMOUNT DUTY.

(16) ALWAYS have only the following totals in the outside right-hand columns of the balance sheet:

<table>
<thead>
<tr>
<th>Item</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Current Liabilities</td>
<td>$xx</td>
</tr>
<tr>
<td>Total Current Deferred Income</td>
<td>$xx</td>
</tr>
<tr>
<td>Total Long Term Debt</td>
<td>$xx</td>
</tr>
<tr>
<td>Total Long Term Deferred Income</td>
<td>$xx</td>
</tr>
<tr>
<td>TOTAL LIABILITIES</td>
<td>$xx</td>
</tr>
<tr>
<td>TOTAL CONTINGENCY RESERVES</td>
<td>$xx</td>
</tr>
<tr>
<td>TOTAL CAPITAL</td>
<td>$xx</td>
</tr>
<tr>
<td>TOTAL LIABILITIES AND CAPITAL</td>
<td>$xx</td>
</tr>
</tbody>
</table>

(17) When the order of the assets is from fixed to current, have the liabilities arranged as follows: long term debts and deferred income, contingency reserves, capital stock and surplus.

(18) "The order of arrangement in the financial statement depends somewhat on the business and the purpose for which the statement is to be used."
1. Is opinion used more often in valuing liabilities than in valuing assets? Elaborate your answer.
2. Why is it necessary for an auditor to ascertain if the liabilities were properly incurred?
3. Define the term "current liabilities".
4. Is the balance sheet caption, "Liabilities and Capital", better than the caption, "Liabilities"? Why?
5. Why should the balance sheet state a figure representing the Total Liabilities?
6. Give several rules embodying fundamental principles of proper financing.
7. Why should the auditor secure a certificate on liabilities from the client?
8. Give a summary of the auditor's duties when auditing liabilities.
9. Give the presentation of liabilities suggested by the Federal Reserve Board in its balance sheet.
10. What liabilities can you think of which are expressions of opinion?
11. Is the proper presentation of liabilities of great importance? Explain yourself.
12. Name one or two networth accounts which are often erroneously classified as liabilities. Explain.
13. How would you go about ascertaining the accrued expenses payable of the business you are auditing?
14. What is the order of the liability and the networth accounts when the assets are listed from fixed to current?
15. Give the customary wording of English certificates in regard to the auditor's getting information and explanation from the officers of the client.
16. Why should the customary group of items labelled Reserves be abolished? How?
17. Define the term fixed liabilities.
18. What is the rule in regard to offsetting liabilities against assets?
20. What is your opinion of the following? "During the course of the Kylsant trial great emphasis was laid on the necessity of maintaining secrecy so that competitive companies should not be assisted to more intelligent competition. That is an old argument and it is trite. There is, of course, a certain amount of detail of inner working which may with advantage be regarded confidentially, but there is a deal of nonsense in what during the war was called 'hush, hush, stuff.' In these days there are few trade secrets which are not as widely bruited in the trade as any of Mrs. Grudyn's most secret slanders. If a company really wants to know what another company is doing and how it is done, the information can be obtained. But the theory of secrecy is, as an able article in The 19th Century and After said recently, a sort of fetish. It is used as an excuse for a deal of bad practice. If the directors of a corporation wish to withhold information which the stockholders are entitled to have, it is the common practice to fall back upon the excuse of trade secrecy. This is true in Great Britain and America and everywhere else. As a matter of fact it is probably safe to say that in most cases there could be absolute frankness on every detail of a corporation's business without injuring in any way the corporation or its prospects. The public, moreover, is going to demand greater candor than ever before. It
20. (Cont.) is to be hoped that in Great Britain, which is the home of tradition, the experience of the Kylsant case will be taken to heart and we shall hear less of the sanctity of business secrets and more of the facts.\footnote{The Journal of Accountancy, Jan. 1932 (p.4)}

21. What is your opinion of the following? "Auditors have been known to say that they have been helpless because the form of statement rests with the directors. They have said, such auditors, that so long as the legal requirements are met it is impossible to insist upon anything further. In other words, such auditors claim that there is no moral duty higher than a legal duty. The New York stock exchange has taken an active interest in the question of corporate accounts and it seems to be the sentiment of the exchange that compliance with legal requirements is not necessarily enough. The modern, progressive, honest accountant pays very little attention to the legal requirements, except to assure himself that all technicalities have been met, but proceeds to work in the way that will produce the true results. The moral obligation is far greater than the legal.\footnote{Ibid.}
THE VERIFICATION OF NOTES PAYABLE

494. The Notes Payable Register. Whenever the number of notes payable (i.e. promissory notes), accepted two and three party drafts, and accepted trade acceptances are numerous, the client should have a Notes Payable Register (Plate 155). Provision is often made in such a register for recording a complete history of each note, hence the amount of the liability on notes is always readily available by classes and by dates of maturity.

495. See Plate 155.

496. The Auditor's Schedule. The auditor's schedule on notes payable should be prepared from the Notes Payable Register; the total thus ascertained being checked to the balances of the notes payable accounts in the general ledger. As shown in Plate 156, the notes must first of all be properly classified (here notes payable-banks, and notes payable-trade). If the notes are very numerous, only a list of the outstanding ones as of the audit date will be shown if it is a balance sheet audit. But if the notes

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Review Questions.

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494. The Notes Payable Register. Whenever the number of notes payable (i.e. promissory notes), accepted two and three party drafts, and accepted trade acceptances are numerous, the client should have a Notes Payable Register (Plate 155). Provision is often made in such a register for recording a complete history of each note, hence the amount of the liability on notes is always readily available by classes and by dates of maturity.

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**Notes Payable Register**

<table>
<thead>
<tr>
<th>Date</th>
<th>No.</th>
<th>Drawer or Maker</th>
<th>Payee</th>
<th>Acceptor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan</td>
<td>221</td>
<td>Ourselves</td>
<td>D MacMillian Paint Co.</td>
<td>Ourselves</td>
</tr>
<tr>
<td>12</td>
<td>149</td>
<td>The Walker, Brighton Co</td>
<td>D Chadsee &amp; Sons, Inc.</td>
<td>Ourselves</td>
</tr>
<tr>
<td>19</td>
<td>222</td>
<td>Ourselves</td>
<td>D Barlett &amp; Son</td>
<td>Ourselves</td>
</tr>
<tr>
<td>19</td>
<td>410</td>
<td>Barrows Inc</td>
<td>D Barrows, Inc.</td>
<td>Ourselves</td>
</tr>
<tr>
<td>20</td>
<td>223</td>
<td>Ourselves</td>
<td>D Massachusetts Trust Co.</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>224</td>
<td>&quot;</td>
<td>D John Marshall</td>
<td></td>
</tr>
</tbody>
</table>

---

**Accounts**

<table>
<thead>
<tr>
<th>Month</th>
<th>Payable</th>
<th>Name of Creditor</th>
</tr>
</thead>
<tbody>
<tr>
<td>July</td>
<td>16892.87</td>
<td>D MacMillian Paint Co</td>
</tr>
<tr>
<td>Aug</td>
<td>4681.08</td>
<td>D Walker, Brighton Co</td>
</tr>
<tr>
<td>Sept</td>
<td>350.47</td>
<td>Barrows, Inc.</td>
</tr>
</tbody>
</table>

**July 20/31**

**Omissions**

Total 146819.45

---

**Accounts Credited**

<table>
<thead>
<tr>
<th>Trade</th>
<th>Bank</th>
<th>Accounts Payable</th>
<th>Payable</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>16892.87</td>
<td></td>
<td>16892.87</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4681.08</td>
<td></td>
<td>4681.08</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4906.72</td>
<td></td>
<td>4906.72</td>
</tr>
<tr>
<td></td>
<td></td>
<td>350.47</td>
<td></td>
<td>350.47</td>
</tr>
<tr>
<td></td>
<td></td>
<td>50000.00</td>
<td>Notes Payable - Officers</td>
<td>10000.00</td>
</tr>
</tbody>
</table>

**Omissions**

155987.14 100000.00 Totals 175989.73
### Where Payable

<table>
<thead>
<tr>
<th></th>
<th>-Time -</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. Days</td>
<td>Rate</td>
</tr>
<tr>
<td>Our Office</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>First National City</td>
<td>Demand</td>
<td>12</td>
</tr>
<tr>
<td>Our Office</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>Atlas National City</td>
<td>3</td>
<td>4 1/2</td>
</tr>
<tr>
<td>Mass. Trust Co. City</td>
<td>60</td>
<td>21</td>
</tr>
<tr>
<td>Our Office</td>
<td>16</td>
<td>6</td>
</tr>
</tbody>
</table>

---

### DEBITED

<table>
<thead>
<tr>
<th>Interest Expense on Notes Payable - Trade</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes Payable - Trade</td>
<td>48.60</td>
</tr>
<tr>
<td></td>
<td>4960.12</td>
</tr>
<tr>
<td>Prepaid Interest</td>
<td>375.00</td>
</tr>
<tr>
<td>Cash</td>
<td>49625.00</td>
</tr>
<tr>
<td>Officers Salaries</td>
<td>10000.00</td>
</tr>
</tbody>
</table>

---

### Folio

<table>
<thead>
<tr>
<th>Date</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/7/30</td>
<td></td>
</tr>
<tr>
<td>1/12/30</td>
<td></td>
</tr>
<tr>
<td>2/19/30</td>
<td>A renewal of Note #154</td>
</tr>
<tr>
<td>4/19/30</td>
<td></td>
</tr>
<tr>
<td>3/21/30</td>
<td>Renewed for 60 days by Note #53</td>
</tr>
</tbody>
</table>

---

495. Explanation and Comments.—This form of register is fairly complete. The various column headings should follow one another from left to right, but they are placed in groups under each other merely for editing convenience. Short insert sheets will keep the size of the register normal.

Observe that note #149 was drawn on us by Walker, Brighton Co. payable to Chadsee & Sons, Inc.; i.e., we owed them and they owed Chadsee & Sons, Inc.

Finally, note that this register is NOT a memo book, but an actual posting medium. Thus the sum of $146,819.45 was posted to the Accounts Payable controlling account in the general ledger on page 9, as were several other amounts to their respective accounts.
Jordan & Merrill, Inc.

B/S Audit for Year Ending Dec. 31, 1929

<table>
<thead>
<tr>
<th>Payee</th>
<th>CR</th>
<th>Dated</th>
<th>Due</th>
<th>Amount</th>
<th>Interest Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>First National of Boston</td>
<td>Fl-a</td>
<td>5 12/3/29</td>
<td>3/3/30</td>
<td>250000.00</td>
<td>3/3/30</td>
</tr>
<tr>
<td>Chelsea Commercial Bank</td>
<td>Fl-c</td>
<td>5 11/17/29</td>
<td>2/17/30</td>
<td>250000.00</td>
<td>2/17/30</td>
</tr>
</tbody>
</table>

---

OMISSIONS

O.K. per balance of G/L 850000.00 To B/S

---

TRADE

<table>
<thead>
<tr>
<th>Payee</th>
<th>CR</th>
<th>Dated</th>
<th>Due</th>
<th>Amount</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rollins, Inc.</td>
<td>AA-1</td>
<td>6 11/19/29</td>
<td>1/19/20</td>
<td>14689.42</td>
<td>X</td>
</tr>
<tr>
<td>M.P. Ross &amp; Sons</td>
<td>AA-2</td>
<td>6 12/19/29</td>
<td>2/19/30</td>
<td>7981.06</td>
<td>X</td>
</tr>
<tr>
<td>Baker &amp; Baker</td>
<td>AA-3</td>
<td>6 12/13/29</td>
<td>2/13/30</td>
<td>3897.53</td>
<td>X</td>
</tr>
</tbody>
</table>

---

OMISSIONS

O.K. Balance per G/L 12/31/29 347689.42 To B/S

---

497. Explanation and Comments.—In this schedule the auditor simply listed the full details of the notes outstanding at the audit date.

Note that the notes are classified as Notes Payable - Banks, and Notes Payable - Trade.

Note also that the Prepaid Interest and the Accrued Interest Payable were computed by the auditor, and necessitated auditor's adjustment #27.
### RIGHT SIDE OF PLATE 156

<table>
<thead>
<tr>
<th>Prepaid</th>
<th>Accrued</th>
<th>Collateral</th>
<th>Pledged</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>Interest</td>
<td>Payable</td>
<td>Remarks</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fl-a</th>
<th>400 7% Pfd. Shares Goodrich, Oldson &amp; Hodge, Inc.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2152.78</td>
<td></td>
</tr>
<tr>
<td>486.11</td>
<td></td>
</tr>
<tr>
<td>1666.67</td>
<td></td>
</tr>
</tbody>
</table>

**O M I S S I O N S**

<table>
<thead>
<tr>
<th>102.82</th>
<th>A renewal of note #169</th>
</tr>
</thead>
<tbody>
<tr>
<td>15.96</td>
<td></td>
</tr>
<tr>
<td>11.69</td>
<td></td>
</tr>
</tbody>
</table>

**O M I S S I O N S**

<table>
<thead>
<tr>
<th>6467.81</th>
<th>4466.59</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adj. $27</td>
<td>Adj. $27</td>
</tr>
</tbody>
</table>

For audit procedure, see the Audit Program.
A SCHEDULE ON NOTES PAYABLE (2d type) PLATE 157

Wood, Bury & Mason, Inc.

(1) Notes Payable—Banks and (2) Notes Payable—Trade

(LEFT SIDE) B/S Audit for Year Ending December 31, 1929

Banks

<table>
<thead>
<tr>
<th>Dated</th>
<th>Due</th>
<th>Rate</th>
<th>Borrowed Amount</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slater Trust Company</td>
<td>11/14/28</td>
<td>2/11/29</td>
<td>5</td>
<td>200000</td>
</tr>
<tr>
<td>Shawnee Trust Company</td>
<td>12/30/28</td>
<td>2/17/29</td>
<td>5</td>
<td>100000</td>
</tr>
<tr>
<td>Wayne County Bank</td>
<td>12/14/28</td>
<td>1/12/29</td>
<td>5</td>
<td>100000</td>
</tr>
<tr>
<td><strong>12/31/28</strong> Balance per our papers and G/L</td>
<td><strong>400000</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Second National</td>
<td>2/18/29</td>
<td>4/18/29</td>
<td>5</td>
<td>200000</td>
</tr>
<tr>
<td>Shawnee Trust</td>
<td>2/15/29</td>
<td>4/15/29</td>
<td>5</td>
<td>100000</td>
</tr>
<tr>
<td>Industrial Trust</td>
<td>1/4/29</td>
<td>3/4/29</td>
<td>5</td>
<td>100000</td>
</tr>
<tr>
<td><strong>Second National</strong></td>
<td><strong>11/14/29</strong></td>
<td><strong>1/12/30</strong></td>
<td><strong>5</strong></td>
<td><strong>100000</strong></td>
</tr>
<tr>
<td><strong>Wayne County</strong></td>
<td><strong>12/20/29</strong></td>
<td><strong>2/17/30</strong></td>
<td><strong>5</strong></td>
<td><strong>100000</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>2400000</strong></td>
</tr>
<tr>
<td><strong>Paid Up</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>1900000</strong></td>
</tr>
<tr>
<td><strong>Balance per G/L 12/31/29</strong></td>
<td><strong>500000</strong></td>
<td>To B/S</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Trade

<table>
<thead>
<tr>
<th>Dated</th>
<th>Due</th>
<th>Rate</th>
<th>Borrowed Amount</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Atkins &amp; Hawkins</td>
<td>11/12/28</td>
<td>1/18/29</td>
<td>6</td>
<td>14689.42</td>
</tr>
<tr>
<td>Rosenau Bros.</td>
<td>12/20/28</td>
<td>2/17/29</td>
<td>6</td>
<td>10076.42</td>
</tr>
<tr>
<td>Jones &amp; Williams, Inc.</td>
<td>10/21/28</td>
<td>1/18/29</td>
<td>6</td>
<td>491.45</td>
</tr>
<tr>
<td>Baxter &amp; Son, Inc.</td>
<td>11/2/28</td>
<td>1/30/29</td>
<td>6</td>
<td>13689.41</td>
</tr>
<tr>
<td>John N. English</td>
<td>11/14/28</td>
<td>1/12/29</td>
<td>6</td>
<td>21076.37</td>
</tr>
<tr>
<td><strong>Balance per our papers and G/L 12/31/28</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>60022.77</strong></td>
</tr>
<tr>
<td>R.F. Jennings, Inc.</td>
<td>1/8/29</td>
<td>3/8/29</td>
<td>6</td>
<td>2067.49</td>
</tr>
<tr>
<td>Walter &amp; Pomone</td>
<td>1/9/29</td>
<td>3/9/29</td>
<td>6</td>
<td>15689.15</td>
</tr>
<tr>
<td>Jones, Haskins &amp; Co.</td>
<td>1/17/29</td>
<td>3/17/29</td>
<td>6</td>
<td>13969.42</td>
</tr>
<tr>
<td>Atkins &amp; Hawkins</td>
<td>11/20/29</td>
<td>2/17/30</td>
<td>6</td>
<td>22867.56</td>
</tr>
<tr>
<td>Baxter &amp; Son, Inc.</td>
<td>10/21/29</td>
<td>2/23/30</td>
<td>6</td>
<td>14091.97</td>
</tr>
<tr>
<td>Jordan &amp; Jordan</td>
<td>11/14/29</td>
<td>1/12/30</td>
<td>6</td>
<td>1096.04</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>906854.27</strong></td>
</tr>
<tr>
<td><strong>Paid Up</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>861685.42</strong></td>
</tr>
<tr>
<td><strong>Balance per G/L 12/31/29</strong></td>
<td><strong>551660.95</strong></td>
<td>To B/S</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

CR Cash Receipts Book for receipt of the money on issuance of note was seen

CK Cancelled Check for payment of note was seen

CN " Note " " " " " "

BC Bank Charge " " " " i.e. it was not paid by check

AP Account Payable i.e., the note was " on account"

R Renewal

Mdse Taken direct for merchandise
### Accrued Interest

<table>
<thead>
<tr>
<th>Source</th>
<th>Verified Interest</th>
<th>Prepaid Interest</th>
<th>Payable Interest</th>
<th>Interest Expense</th>
<th>Remarks</th>
<th>Paid by</th>
</tr>
</thead>
<tbody>
<tr>
<td>CR CK CN</td>
<td>1166.67</td>
<td>1166.67</td>
<td>1166.67</td>
<td>2000.01</td>
<td>(2000.01)</td>
<td>2000.01</td>
</tr>
<tr>
<td>CR &quot; &quot; &quot;</td>
<td>666.67</td>
<td>666.67</td>
<td>666.67</td>
<td>833.33</td>
<td>833.33</td>
<td></td>
</tr>
</tbody>
</table>

**This collateral is at CK CN**

**This bank. 550 Common shares Central Sugar Refining Co.**

| AP CK CN | 202.15 | 100.74 |
| " " " | 5.09 | 7.37 |
| Mdse " " | 136.89 | 205.34 |
| AP CK CN | 168.61 | 210.75 |

**434.36**

**Not verified direct**

**CK CN correspondence**

**4812.06**

**1681.94**

**12164.47**

498. Explanation and Comments.-The auditor has analyzed the two accounts for the entire year.

Note in the column headed, "Source" that the auditor took care to find and designate how the notes arose. This procedure is necessary that he may know that he is classifying them properly. Thus, he found that the notes due to the bank arose from loans, and that the notes due to the other creditors arose from trade transactions. Moreover, he knew from this investigation how many of the notes were renewals. Obviously, information of this latter type is invaluable. Again, note that in the "Paid" column it is shown that all notes due before the auditor left on 2-18-30 were paid. This data should always be gathered and given in the report.

Finally, observe that the notes payable-banks ($5,000.00) were indexed to the letters (filed back of cash schedules) from the banks, and that the notes payable-trade ($58,168.85) were indexed to the letters from the trade creditors.
A SCHEDULE ON NOTES PAYABLE (3d type) PLATE 158

Merrill & Merill, Inc.
Notes Payable - Banks

B/S Audit for the Year Ending June 30, 1930

<table>
<thead>
<tr>
<th>Dated</th>
<th>Due</th>
<th>I</th>
<th>Prepaid</th>
<th>Banks</th>
<th>Sched 6/30/30</th>
<th>Interest 6/30/30</th>
<th>Balance 6/30/30</th>
<th>Paid 6/30/30</th>
<th>To B/S 6/30/30</th>
<th>8/9/30</th>
</tr>
</thead>
<tbody>
<tr>
<td>5/6/30</td>
<td>8/5/30</td>
<td>6</td>
<td>Atlas National A-3</td>
<td>650.00</td>
<td>100000.00</td>
<td>100000.00</td>
<td>0.00</td>
<td>8/9/30</td>
<td>8/9/30</td>
<td></td>
</tr>
<tr>
<td>6/6/30</td>
<td>9/4/30</td>
<td>6</td>
<td>State Street Trust A-1</td>
<td>550.00</td>
<td>50000.00</td>
<td>100000.00</td>
<td>0.00</td>
<td>8/9/30</td>
<td>8/9/30</td>
<td></td>
</tr>
<tr>
<td>5/19/30</td>
<td>8/17/30</td>
<td>6</td>
<td>Industrial Trust AA2-a</td>
<td>850.00</td>
<td>150000.00</td>
<td>150000.00</td>
<td>0.00</td>
<td>8/9/30</td>
<td>8/9/30</td>
<td></td>
</tr>
<tr>
<td>5/9/30</td>
<td>8/7/30</td>
<td>6</td>
<td>Slater Trust AA2-b</td>
<td>950.00</td>
<td>100000.00</td>
<td>100000.00</td>
<td>0.00</td>
<td>8/9/30</td>
<td>8/9/30</td>
<td></td>
</tr>
<tr>
<td>6/24/30</td>
<td>8/23/30</td>
<td>6</td>
<td>Mass. Hospital Trust A-5</td>
<td>300.00</td>
<td>100000.00</td>
<td>100000.00</td>
<td>0.00</td>
<td>8/9/30</td>
<td>8/9/30</td>
<td></td>
</tr>
<tr>
<td>Balance per G/L 6/30/30</td>
<td>3000.00</td>
<td>100000.00</td>
<td>100000.00</td>
<td>0.00</td>
<td>8/9/30</td>
<td>8/9/30</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| ADDITIONS 6/30/30 to 8/9/30

7/6/30  9/4/30  6  Atlas National A-3  | 500.00 |
7/16/30 10/16/30 6  Mass. Hospital Trust AA2-c | 500.00 |
7/28/30 9/25/30 6  First National A-4   | 50000.00 |
8/2/30 10/31/30 6  Seaman's Commercial A-7 | 50000.00 |
8/15/30 9/4/30 6  Wayne County Trust AA3-d | 100000.00 |
| Total | 500000.00 | 250000.00 |
| Balance per G/L 8/9/30 | 550000 |

AUDIT PROCEDURE

The account was completely analyzed for the whole year. All notes were traced to the Cash Receipts Book. All cancelled notes were examined. Payments were traced to cancelled checks or bank charges and to the Cash Payments Book.

1. Traced into Cash Receipts Book

2. Traced into Cash Payments Book. Cancelled check or bank charge and cancelled note were examined.

499. Explanation and Comments.—The chief point of interest in this schedule is the fact that the auditors examined and verified the account both at June 30 and at August 9. This verification was necessary in order to make the cash verification complete, since this part of the audit was not completed until August 9. As explained in the text in Chapter 12 on The Verification of Cash, it is important that the cash account and its chief allied accounts be audited beyond the audit date up through the day of the actual auditing of the account.

Note that the schedule is poorly drawn up in that it does NOT end with the June 30, 1930 balance.

Finally, observe that each note has been confirmed by direct correspondence.
are few in number, or if it is a detailed audit, the transactions for the year (Plate 157) are often worked up, including the accrued interest payable, the interest expense, and the prepaid interest (discount on notes payable).

497. See Plate 156.

498. See Plate 157.

499. See Plate 158.

500. The Date to Which to Audit.—In the case of notes payable—banks, or other notes representing loans, the writer deems it advisable for an auditor to bring his audit up to the very day of the actual auditing, even if it is one or two months after the audit date (Plate 158). This procedure is necessarily a part of the cash verification outlined in chapter 12. For example, it is possible for a client to secure (but not record) a loan just before the audit date to make good a cash shortage. If the entry for the loan is not made on the books of account by the time the auditor audits the notes payable, the irregularity might be revealed (otherwise not) if the auditor brings his audit up to date, and also makes his confirmations of notes read both as at the audit date and as at the date of actual auditing work. On the other hand, if the client has recorded the transaction immediately after the audit date, (i.e. anytime before the date of the actual auditing) the cash shortage will be caught if the auditor brings the audit of cash alone up to date.

501. Checking the Notes to the Schedule.—After the auditor has prepared his schedule from the Notes Payable Register, he should check the cancelled notes on hand against the schedule, and the others against the register if his schedule is of the type shown in Plate 156. As a result of this checking, there will be certain unchecked notes, e.g. those which are outstanding. As a rule these notes will be verified by direct correspondence if they represent cash loans, amounts due to affiliated companies, large trade debts, or debts to officers (Plate 159). Ordinary small notes, drafts, and acceptances payable to trade are often not verified beyond a test at most. As just stated in section 500, the auditor will find it worth while to get these confirmations both at the audit date and at the date of the actual auditing work.

As indicated in the Source column of Plate 157, it is advisable for the auditor to ascertain the origin of all notes, or at least of all outstanding notes. Thus outstanding notes payable to banks should be checked to the cash receipts book, the trade notes to accounts payable by name, etc.. The value of this procedure lies in the fact that the auditor makes certain as to the regularity of the notes, i.e. that they have been properly incurred. Moreover, he then knows that he has properly classified them. Likewise, all note renewals and/or payments of overdue accounts will have been ascertained. All three of those points must be thoroughly

1 It would not be caught, for example, if the loan was secured from a bank or other source to which the auditor would not be likely to send a confirmation letter. 2 As it is only in the case of receivables that a client can advance the argument (complaint) that he fears the loss of customers if the accounts and notes are circularized, the auditor should circularize the trade notes payable, if the creditors' monthly statements do not list them. If the client objects to this procedure, the auditor should state the facts either in his certificate or report as seems best. Moreover, the auditor should remember to circularize not only the holders at the audit date but also those who were holders at any time during the period.
502. See Plate 159.

503. Additional Features of the Verification. — As a part of his verification of notes payable, the auditor should ascertain from the by-laws, directors' minutes, or other places, the names of the officers who have been empowered to sign the notes, and what restrictions, if any, have been placed upon them. In addition to this, the auditor must keep in mind the possible limitations imposed by bond issues, etc. It is very important for the auditor to call attention to any breach, or threatened breach, of this sort.

A customary angle of approach in auditing notes payable is through the interest expense, and the prepaid, and accrued interest accounts. As shown on plates 156, 157 and 158, these three accounts are analyzed to various degrees depending upon the type of audit, or upon the number of note transactions. In any case, the competent auditor always makes some sort of a test of these accounts. Thus, if a bank discount of $1,000 were found in the prepaid interest account as of April 17, it would be definitely traced to a particular note payable of the proper amount, time, discount rate and date. Many frauds have been uncovered as a result of this simple procedure.

Whenever the auditor runs across a note payable which arose out of a purchase of fixed assets, such as machinery and equipment, he should ascertain the full facts thereof. Sometimes a client will charge the fixed asset account only as he pays off a note; i.e., he will not have made an entry when he issued the notes. Obviously, the whole asset purchase, and all of the chattel mortgage notes issued against it, must be recorded. If interest is included in the face of the notes, the auditor must be careful to charge it to prepaid interest, not to the machinery account. From what has been said here, it should be clear that a review of the cancelled notes (Sec. 501) is not a waste of time by any means. Of course, the analysis of the machinery account might have disclosed the above facts; then again, it might not. Even so, as emphasized before, it is well worth one's time to have his audit procedure overlap at important key points. To cover the same ground twice is wasteful, but to cover the same ground twice from each of two different angles of approach is wise strategy.

As has been pointed out, notes payable—banks and brokers; large notes to trade, notes to officers; and to subsidiaries are generally confirmed by direct correspondence. To this one other comment should be added; namely, that each bank with whom the client is at present doing, or has recently done business should be questioned on this point, even if the books do not show any notes under discount with it. (Plate 160).

504. See Plate 160.

505. Collateral Notes. — When auditing certain types of clients, the auditor should be watchful for instances where the client has arranged for a bank to accept drafts against bills-of-lading, etc. (Plates 73, 74, 161, 162 and 163) and yet has not made an entry to record these facts. It is common, for example, for a bank to accept drafts drawn on bills-of-lading against a client, and then place the goods with the client under a Trust

If any notes have been sent to brokers for sale but are unsold, these may be omitted from the balance sheet. It is preferable however to show the notes less those unsold, the net being carried into the money column.

The auditor must remember that notes payable to officers are very apt to be secured in some manner.

See the end of this chapter.
Dear Sir:

Please confirm, to our auditors the following statement of our notes sold through you and outstanding as at _______________.

A stamped and addressed envelope is enclosed for your convenience.

Cordially yours,

By

Dear Sirs:

The following is a COMPLETE statement of the notes of which were sold through us and were outstanding at ______________ 193.

Yours Truly,

By

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
<th>Due</th>
<th>Int. Rate</th>
<th>Description</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

502. Explanation and Comments.—Whenever outstanding notes payable have been sold through note-brokers, the amount, etc. must be verified by direct confirmation.

This form, addressed to the note-brokers (upper half), is signed by the client, the date of request being as at the audit date, and as at the date of auditing, or preferably two blanks dated respectively at the two dates. The note-brokers are expected to sign the lower half and mail it to the auditors in the enclosed stamped and addressed envelope.

The lower section of the bottom half of this form should be left blank to be filled in by the note-brokers. This procedure is better than for the auditor to fill it in, because the verification is more independent; i.e., the note-brokers are not told the answer expected of them.

The auditor should read and mail the form after it has been signed by the client. This precaution prevents the client from asking the note-brokers different questions than those requested by the auditor. The client, for example, might not send the auditor's form at all, but a letter of its own. As businesses (here, the note-brokers) very often do not use the auditor's form when replying; a letter (instead of the form) from the note-brokers would not arouse the auditor's suspicions. In brief, it is a very simple matter for the auditor to examine and mail the confirmations. Therefore, he should do it, as it cuts off a very definite avenue of fraud.

Many businesses prefer to use their own letter heads so that they may retain a carbon copy of all important correspondence.
The Atlas Commercial Bank,  
Pawcatuck, Conn.  

Gentlemen:  
Please confirm to our auditors the balance of our account with you at the close of business on June 30, 1930.  
At the same time please advise them that at that date you did NOT hold any notes or drafts signed, accepted, guaranteed, or endorsed by us.  
A stamped and addressed envelope is enclosed for your convenience.

Cordially yours,  
HOLDEN & HOLDEN, INC.  
By Geo. Holden

504. Explanation and Comments.—As stated in the text, the auditor should question each bank with whom the client is at present doing, or has recently done, business as to notes payable, even though the ledger does not show any notes under discount.

The following is a form of letter used in circularizing trade notes and acceptances payable.

Gentlemen:  
Please advise our auditors, Messrs. Snow, Walker & Burroughs,  
Central Falls, R.I. the amount of our liability (if any) to you at the close of business on --- --- --- on notes and/or acceptances, Etc., giving the amount, date, time, interest rate, and date to which the interest is paid. If secured, please give a full description of the security and its amount.

Cordially yours,
Receipt (Plate 73), or place them in a warehouse until paid for. Usually the client has to place funds (to meet the acceptances) with the bank one day before the maturity thereof. On other occasions the bank may finance the transaction for a longer period. Meanwhile the client, under our suppositions, has not made any entry to record the fact that from an accounting point of view it owns the goods and has issued thereon collateral notes payable, or the equivalent. It is entirely wrong for the client to ignore the situation until he is obligated to pay out money. He is definitely under contract at the acceptance date to take the goods from the bank at cost and expenses, whatever may happen to their market value. Moreover, even if the market value is the same as cost, a suppression of these facts is a cancellation of a liability against an asset (Sec. 486). Such an irregularity might have a tremendous bearing upon the current ratio, or if the facts were known, they might alter the opinion of a banker or of a credit manager who is about to consider extending a line of credit.

It should be recalled that notes payable are often secured by an assignment of accounts receivable. If the borrower’s customers are not notified of the assignment of their accounts, it is customary for the lender to demand that the borrower place a stamp across the face of each of the pledged accounts. The stamp states in effect that on a certain date it was assigned to the lender. As soon as money is received on these accounts, it is forwarded to the lender. If the borrower should be so unfortunate as to pass into the hands of a receiver, the lender can seize these claims for himself, in which case he would notify the customers to remit to him direct. Any excess received above the note liability becomes the property of the receiver. Any deficiency becomes a general unsecured claim against the receiver.

Under a second plan, the customer is notified of the assignment of his account as soon as it takes place. He is also instructed to send his remittances direct to the bank or finance company. In either case it is the duty of the auditor to verify direct with the lender the amount of the note liability, the amount of the guarantee deposit, the amount of the pledged accounts, etc. Furthermore, the auditor must be careful of his balance sheet presentation of these facts.

Another type of collateral note payable is that whose security is stocks and bonds (Plate 164). The auditor must verify this collateral either by inspection or by direct correspondence with the holder, usually the latter. Furthermore, he should ascertain why the collateral had to be posted.

Sometimes a business will borrow against merchandise which it already owns (Plate 89). As in the case of new goods never owned by the business, the bank may allow the borrower to have custody of the goods, or it may place them in a warehouse under its own authority. In the former case, the borrower agrees to keep the goods separate from other goods, and to apply the proceeds from the sale thereof to the reduction of the loan. If the business fails, the lender can seize the property. In the latter case, the lender usually releases the goods only in proportion to the reduction of the loan.

506. See Plate 161. 507. See Plate 162.

508. See Plate 163. 509. See Plate 164.

510. See Plate 165.
EXPLANATION OF PLATE 161

A LETTER OF CREDIT

LETTER OF CREDIT
LAUCK, LOGAN & CO.
Boston, Mass.

506. Explanation and Comments.--(a) Export Credits -- "A large portion of this (export) business is being transacted against credits established by American banks. That is to say, when an American bank of credit is stipulated in the negotiation for the purchase of goods or merchandise from an American seller, and the deal is concluded, the foreign buyer arranges for his local bank to establish with its New York bank correspondent a credit expressed in dollars in favor of the seller. On receipt of these instructions, frequently by cable, the American bank establishes the credit and notifies the seller of the details, quoting the amount, the documents required, etc. In due course the seller prepares the goods or merchandise for shipment, receives the necessary documents, and presents them to the bank issuing the credit. The bank, after carefully examining the draft and documents and finding them in accordance with the terms of the credit, pays the amount involved."

(b) Import Credit--"The commercial letter of credit is the recognized medium for financing importations (or exportations) of merchandise. It protects the importer, first, because he is provided with the means of purchasing goods from a foreign country on a cash basis without being required to put up actual cash (provided his credit standing is satisfactory); and, second, because the foreign seller or exporter does not receive his money until he has surrendered documents evidencing shipment of the goods ordered. On the other hand, the exporter, if he is in possession of a letter of credit, knows that when the shipment has been made and the relative documents received, he can go to his bank and obtain counter value." (How Business with Foreign Countries is Financed--(1928) Guaranty Trust Company of N. Y.)
LETTER OF CREDIT
LAUCK, LOGAN & CO.
BOSTON, MASS.

Date: Jan 12, 1931
Irrevocable: Yes
L.C. No.: 42051
Amount: $4200.00
Expires: March 12, 1931

The Ling-Silk Co.
Canton, China

Dear Sirs:

We authorize you to draw on The First Merchants Bank of New York
against the account of Paul_Morga & Co., Boston, Mass.
for any sum or sums not exceeding in all—Four thousand and four hundred Dollars
available by your drafts at six (6) months sight
when accompanied by the following documents:

- Invoice
- Consular Invoice
- Insurance Policy
- Full set of Bills of Lading

evidencing shipment of: Bales of Raw Silk 461515
From Canton, China
To Boston, Mass.

Insurance to be effected by The Central Falls Mutual Fire Ins. Co., R.I.
The Bills of Lading to be made out to the order of Lauck, Logan & Co.

Drafts drawn under this credit must state that they are drawn under
Lauck, Logan & Co.'s Letter of Credit, numbered and dated as above.

The bank negotiating the draft must forward by early mail direct to
Lauck, Logan & Co., Boston, one copy each of the Invoice, Consular Invoice,
and Bill of Lading.

A letter certifying that this has been done, and all the remaining
documents, must accompany the draft.

The amount of any draft drawn under this credit must be endorsed on
the reverse hereof, and the presentation of each draft, if negotiated, shall
be a warranty by the negotiating bank that such endorsement has been made
and that the documents have been forwarded as herein required; if the draft
is not negotiated this credit and all relative documents must accompany the
draft.

This credit must accompany any draft which exhausts the credit and
must be surrendered concurrently with the payment of such draft.

Each of the provisions on the bank hereof, except so far as other-
wise expressly stated, is incorporated as part of this credit.

We hereby engage with the drawers, endorsers and bona fide holders
of drafts drawn under and in compliance with the terms of this credit that
the same shall be duly honored on presentation and delivery of documents
as specified, if negotiated or presented on or before March 12, 1931.

Yours faithfully,

LAUCK, LOGAN & CO.

By James Lauck

Countersigned: Morton P. Logan
EXPLANATION OF PLATE 162

A DRAFT DRAWN UNDER A LETTER OF CREDIT

507. Explanation and Comments.—This draft has been drawn by the Ling Silk Co. at 6 months sight against Letter of Credit A 2051. The draft is payable to the order of The Wong Bank, Canton, China which is the drawer's bank, and is addressed to The First Merchants Bank, the drawee.

Upon paying the draft, the Wong Bank makes the following endorsement on the back of the Letter of Credit (Plate 161).

RECORD OF DRAFTS DRAWN

<table>
<thead>
<tr>
<th>Date</th>
<th>Negotiating Bank</th>
<th>Amount in Words</th>
<th>Amount in Figures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/24/31</td>
<td>The Wong Bank</td>
<td>Eight Hundred Forty-Six</td>
<td>$846.00</td>
</tr>
<tr>
<td>Canton, Ch.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

PROVISIONS FOR INTERPRETATION OF CREDITS

("It is insisted that all acceptances outstanding as of statement date, and advised to the company, should be included in the liabilities and the merchandise in transit included in the inventory as a separate item.
"It is also insisted that the unused credits outstanding as of statement date be shown in a footnote on the statement")—by Mr. M. R. Riley

"Mr. Staub: I would like to raise the question as to what is the real difference in principle between unused balances of letters of credit, where no drafts have been advised, and ordinary merchandise commitments?
"Mr. Riley: There is quite a difference. When a banker opens a credit for his customer, that credit has a definite expiration date put on by the banker months hence. In troubled times like these, that date would not be as far ahead as in normal times. The banker has a direct obligation to honor drawings made before the credit expires. The banker, to save his own credit standing, has to accept those drafts and meet them at maturity whether the customer does or not. The customer may fail in the meantime, but the banker still has a direct liability, while the customer has no control over drawings, once the credit is advised. In the case of merchandise commitments, adjustments can be made in price, quality, quantity and, in many cases, can be cancelled. In other words, the customer in one case has no control over the future obligation, while in the case of merchandise commitments, he can exercise some control."—"Relations Between Accountants and Bankers"—N.Y.S.S. of C.P.A. Nov. 1931 (p.10)
A DRAFT DRAWN UNDER A LETTER OF CREDIT  PLATE 162

$3,465.00  No. 817  No. 1  Canton, China  Jan. 24, 1931

At Six (6) months sight drawn against letter of credit #A_2051

of Lauck, Logan & Co., dated Jan 12, 1931 against

Raw Silk #8151_B pay to the order of Tho. Weng Bank, Canton, China

---Eight Hundred Forty Six and No/100------Dollars

Value received  which place to account of

To The First Merchants Bank

of New York

N.Y., U.S.A.

Charge to the account of Paul Moreno & Co., Boston, Mass.
Explanation and Comments.--This plate represents a draft drawn under an Acceptance Agreement such as the following one.

**ACCEPTANCE AGREEMENT**

(Foreign)

No. ______

TO THE ATLAS NATIONAL BANK OF BOSTON

We hand to you herewith, for acceptance, our draft(s) drawn on you at _____________ days sight, No. _____________ dated _____________ to the order of

for $ _____________. It is agreed that the proceeds of said draft(s) will be used to finance the importation or exportation of goods as per particulars below.

<table>
<thead>
<tr>
<th>PARTICULARS</th>
<th>AMOUNT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In consideration of your acceptance of the said draft(s), the undersigned jointly and severally, agree to pay you at the time of the acceptance a commission of ____________ per cent., and further agree to pay you the amount of the said draft(s) at your office one day before the maturity thereof. We waive all liability on your part in case the goods are not according to contract either in description, quality or in any other respect. All bills of lading, warehouse receipts and other documents of title and all moneys and goods held by you as security for any such acceptance shall also be held by you as security for any other liability from us to you whether then existing or thereafter contracted.

We further agree to give and furnish you on demand additional security or to make payment on account in amounts and character satisfactory to you. If we fail to comply with any such demand or in case of our insolvency, assignment, bankruptcy or failure in business, all our obligations and liabilities direct or indirect to you whether arising hereunder or otherwise shall forthwith become due and payable without demand or notice. All goods represented by bills of lading, warehouse receipts or other documents of title pledged with you as security for your acceptances hereunder, shall be at all times covered by us by certificates of insurance under open policies to your order, or by specific policies payable to you as your interest may appear, to an amount sufficient to cover your advances or obligations hereunder, and you are to have specific claim and lien on such policies and their proceeds to the amount of your interest in the goods thereby insured.
Upon our failure to comply with any of the terms hereof or upon the non-payment by us of this or any other liability to you when due or at any time or times thereafter then in any such case all obligations and liabilities direct and contingent from us to you whether arising hereunder or otherwise shall at your election forthwith become due and payable without demand or notice and we hereby give to you full power and authority to sell, assign, transfer and deliver the whole or any part of the securities, bills of lading or documents of title or the goods represented thereby or of any security substituted therefor or added thereto at any brokers board or at public or private sale with or without notice or advertisement at your option and do further agree that you may become a purchaser at such sale if at any broker's board or at public auction and hold the property or security so purchased as your own property absolutely free from any claim of or in the right of ourselves. In case of any sale or other disposition of the whole or any part of the security or property aforesaid, you may apply the proceeds of such sale or disposition 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 other property or the value thereof as hereinafter provided and may apply the residue of such proceeds to the payment of this or of any then existing liability of ours to you whether then payable or not, returning the overplus to us and in case of any deficiency we agree to pay to you the amount thereof forthwith with legal interest. You may also upon any such non-payment apply the balances of all our deposit accounts in the same way that you are authorized to apply the proceeds of any sale of the security or property hereunder.

You may pay taxes, charges, assessments, liens or insurance premiums upon the security or any part of it, or otherwise protect the value thereof or of the property represented thereby, and may charge against us all expenditures so incurred; but you shall be under no duty or liability with respect to the protection or collection of any security held hereunder or of any income thereon, nor with respect to the protection or preservation of any rights pertaining thereto, beyond the safe custody of such security. We hereby agree that if, in your opinion, the market value of the security hereby or hereafter pledged to secure this obligation, after deducting all charges against the same, is at any time less than the amount thereof and the profit made on the sale of the security, we 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 obligation plus such additional percentage.

We hereby agree to indemnify you against any liability or responsibility for the correctness, validity, or genuineness of any documents of any signatures or endorsements thereon representing goods which you hold, purchase or sell under this engagement, or for the description, quantity, quality or value of the property declared therein, or of any insurance certificates or policies, and against any general loss or charges or other expenses accruing with respect to such goods through delay in transmission of shipping documents or through any other cause, which charges and other expenses we agree to pay. We further agree that no delay on your part in exercising any right hereunder shall operate as a waiver of such right or of any right under this obligation.

All rights arising under this agreement shall be determined according to the laws of the Commonwealth of Massachusetts.

Dated

(Continuation of Explanation of Plate 163)
No. 561 $17,691.48 — Pawtucket, R. I. — July 17, 1930 — — —

At Ninety Days __________ Sight pay to the order of The German Steel Co. __
the sum of Seventeen thousand Six hundred Ninety-one and 48/100 __ Dollars

To __ The Atlas National Bank __________ By __ The Iron Products Corporation __
— 7091 Chicago Ave. __________ — 671 John St. __________ —
— Boston, Mass. __________ — Pawtucket, R.I. __________ —
(Signed) __ William L. Pendleton __________
Treas.

The following stamp was placed vertically across the face of the above note, and then filled in as shown.

ACCEPTED

Date — — July 17, 1930 — — — — — —
Bank — The Atlas National Bank — — — — — —
Location — Boston, Mass. — — — — — —
By — Robert S. Cushman — — — — — —
Cashier
511. The Balance Sheet Presentation.-- As stated in Chapter 31, the proper presentation of liabilities is extremely important. Notes payable should first of all be divided into two main groups; namely, those which are secured and those which are unsecured. For credit, or for internal management purposes, the secured obligations should be divided into (1) those secured by equipment or other plant properties, (2) those secured by liens on inventories, (3) those secured by assigned customers' accounts, (4) those secured by deposits of securities, (5) those secured by _____________. Likewise, unsecured notes should be detailed somewhat as follows: (1) notes payable to banks for money borrowed, (2) notes sold for money through note brokers (Plate 166) (3) acceptances, notes, and drafts given for merchandise, raw materials, or supplies (4) notes given to subsidiaries or parent companies for money borrowed, (5) notes given for plant properties, (6) trade notes given to subsidiaries or affiliated companies in the ordinary course of business, and (7) notes due to stockholders, officers, or employees. Moreover, if there is any sizable amount of renewals or overdue notes; these must be designated in some manner such as, Notes Payable—Trade (overdue $51,800.14) . . . . . $217,619.45.

The suggested segregation of secured notes is absolutely necessary if the balance sheet is to present a clear cut picture of the company's affairs. The asset side of the statement will show separately the amount of the various pledged properties. By comparing these pledged items with their respective secured note—claims, the interested party can ascertain the desirability of his extending a line of credit, etc.

Likewise, it is no fanciful idea to present the unsecured claims in the detail outlined above. Banks always want to know what amount is already being borrowed through other banks. Then too, as it is unusual for a business to sell its notes through note-brokers unless its bank line of credit is at its maximum, a statement of such notes is important information. A separation of trade notes from other notes, such as for plant properties, is obviously highly desirable, for it is an important figure to be compared with the amount of trade accounts payable, i.e. in a type of business which does not regularly give notes direct to the trade. Then too, the sum of the trade notes and the trade accounts payable is an important figure in relation to the merchandise purchases, especially if the overdue accounts and notes are not segregated or noted in some manner. Finally, amounts due to affiliates, or to officers, are significant to the creditor because, among other things, it is very likely that, being on the inside, these notes will be paid off first if "bad" threatens to become "worse".

512. See Plate 166.

513. See Plate 167.

1 More and more it is becoming the best practice for the auditor to show the overdue receivables and payables on the face of the balance sheet.
EXPLANATION OF PLATE 164

A FORM OF COLLATERAL NOTE PAYABLE

509. Explanation and Comments.—The reader should become familiar with the general contents of a collateral note payable, noting particularly in this case how completely the bank has protected itself by the various stipulations in the note. The back of the note is printed the following:

"IN CONSIDERATION of one dollar, paid to the undersigned, the receipt of which is hereby acknowledged, and of the making, at the request of the undersigned, of the loan evidenced by the within note, the undersigned hereby waives demand of payment, protest and notice of protest thereof, and guarantees and becomes surety for its punctual payment, at maturity, to the Levin National Bank of Detroit, its successors, endorsee, or assigns, agreeing and covenanting to pay the same to the holder with interest, when thereafter called upon so to do. The undersigned further assents to all the terms and conditions in said note contained, and particularly agrees that the holder may accept partial payment or payments on, and grant extension or extensions of said note, and may accept such exchange of securities for said loan, from time to time, and (if and when partial payments are made) surrender such portions thereof, as to the holder may seem proper, all with or without notice, and without prejudice to this covenant and guarantee, the undersigned remaining bound hereby, notwithstanding such extension, exchange or surrender."
Detroit, ___ __ 19__

...after date the UNDERSIGNED, for value received, hereby promises to pay to the order of ___ ___ ___ ___ ___, at the LEVIN NATIONAL BANK, ___ ___ ___ ___ ___, in Current Funds, without defalcation, and PLEDGES herewith, as collateral security for the payment of this note, as well as for the payment of all other INDEBTEDNESS or LIABILITY of the undersigned to the holder hereof, whether absolute or contingent, as maker or endorser, drawer, acceptor or guarantor, now existing, or which may hereafter be contracted or incurred, the following described property, viz.:

--- of the market value of ___ ___ ___ ___: and should either said market or the actual value decline, the undersigned further agrees, without notice or demand, to maintain at all times an equivalent margin by partial payment hereon, or in lieu thereof, at the option of the holder, by the pledge of additional securities satisfactory to the holder, and also hereby gives a lien for the amount of all liability, absolute or contingent of the undersigned to the holder upon all the securities and funds of the undersigned, now or hereafter in the hands of or under the control of the holder.

Upon the failure of payment, or performance of the covenant for maintenance of margin, as herein agreed, or upon non-payment of any liability hereby secured, or in the event of the insolvency, bankruptcy or failure in business of the undersigned, this note and all other liabilities of the undersigned to the holder shall forthwith become and be due and payable without demand or notice, and the undersigned hereby grants to the holder full power and authority to sell, assign and deliver, at any time and from time to time, without advertisement, notice or demand, the property hereby or in the hands of or under the control of the holder or any of it or any additions thereto or substitutions thereof, at any Board of Brokers or Stock Exchange or at public or private sale, also the right to bid or purchase at any sale thereof (except private sale) and to become the absolute owner of said property, or any of it, free and clear of any trust or claim or right of redemption of the undersigned or assigns. In the event of a sale of said securities or any of them, the undersigned grants to the holder the right to apply the proceeds thereof (after deducting all cost or expenses of any kind, for collection, sale and delivery) on account of this note and interest, or on account of any of the liabilities of the undersigned, to the holder, whether the same be then due or not due, provided proper rebate be made for interest on liabilities not then due. Any surplus of sale over and above amount of all liabilities, absolute and contingent, of the undersigned to the holder, with interest and all expenses, shall be paid to the undersigned or assigns.

It is further agreed that the holder may, at any time, without notice to the undersigned, sell or transfer this note and deliver same together with said collaterals, to the purchaser or transferee, and shall thereby be forever released and discharged from liability or responsibility for said collaterals.

Dut __ __ __ __ __
Address ___________________________ ___________________________
Dear Sir:

Please fill in the following form. It is a statement of your loan to us at __________. Kindly send it to our auditors, Messrs. Brown and Aldrich, Binghamton, Mass.

A stamped and addressed envelope is enclosed for your convenience.

Cordially yours,

By ____________________________

Treas.

---

Messrs. Brown and Aldrich,
621 Strauss St.,
Binghamton, Mass.

Dear Sirs:

The following is a correct statement of ALL of the contingent and direct liabilities of ______________ as at ______________.

Very truly yours,

By ____________________________

Treas.

---

<table>
<thead>
<tr>
<th>Description</th>
<th>Dated</th>
<th>Amount $</th>
<th>Int. Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Due</th>
<th>Int. Rate</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

510. Explanation and Comments.— The upper half of this form, addressed to the note creditor, is signed by the client, the date of request being as at the audit date, and sometimes also as of the date of the actual auditing work.

As emphasized in the Explanation and Comments of Plate 159, the auditor should examine and mail these forms personally after the client has signed them.
A FORM OF NOTE USED IN OPEN MARKET BORROWING  

$5000.00  
No. 118  
Due April 18, 1929  
January 18, 1929

--- Three Months --- after date --- We --- promise to pay to the order of --- Ourselves ---

--- Five Thousand and No/100 --- Dollars ($5000.00).

Payable at --- The State Street Trust Company of Scrub, R.I. ---

HOLT GOGO HADLEY & CALDER CO.

By  F.F. Ewing  Treasurer

512. Explanation and Comments.— If a business should want to borrow $100,000 in addition to its existing lines of bank credit, it will probably do so through note brokers. If the arrangement with the brokers is successful, the client will not make out a single note for $100,000, but rather a number of $5,000 and $10,000 notes to the extent of $100,000. These notes are often made out payable to self and endorsed in blank on the back.

As a rule, the note broker will buy the notes outright at a discount (i.e. present value) less a commission fee. Thus if interest on the market is at 6%, and if the broker's fee is 1/4 of 1%, the client would get on the illustrated note 98 1/4% (100% minus 1 1/2% (3 months' discount at 6% per annum) minus 1 1/4 (fee)) of $5,000, i.e. $4,612.50.

The function of the broker is not to hold the notes as an investment, but to dispose of them to various banks, who are eager to distribute their investments widely by taking small amounts of paper of a number of businesses. Metropolis banks often use this method for investing money sent to them by country correspondent banks for temporary investment.

Sometimes the note broker acts solely as an agent.
(1) Ascertain from the bonds payable by-laws, and/or directors' minutes if any restrictions (amount, purpose, signatures required) are placed on the issuance of notes.

(2) Prepare a notes payable schedule (one or more) from the Notes Payable Register. If the latter does not exist, then prepare the schedule from the general ledger account(s). Classify the notes properly in a final summary for the balance sheet.

(3) If the notes are few, or if it is a detailed audit, the transactions for the entire period should be developed on the above schedule.

(4) As a rule, the schedule should include columns for accrued interest payable, interest expense, and prepaid interest (discount on notes payable), if these items can be developed from the other facts given on the schedule.

(5) In the case of notes representing loans, it is necessary to account them for the period between the audit date and the date of auditing. The date of auditing should be that chosen to audit the cash and negotiable securities.

(6) See that the various column totals on the schedule are in agreement with their respective general ledger account balances.

(7) Secure all paid up notes. See that they have been properly cancelled. Check them into the schedule, and into the Note Register if it is not a duplication of work.

(8) Verify by direct confirmation the notes not checked on the schedule. In the case of ordinary small notes, drafts, and acceptances payable to trade a test check is usually sufficient. Cash loans, sums due to subsidiaries, large trade debts, debts to officers, etc. should always be verified both as at the audit date and as at the date of the actual auditing work.

(9) If a note payable book (containing the stubs and the blank notes) does not exist, the auditor should recommend one. All notes should be numbered by the printer.

(10) Obtain the note payable book and check the cancelled notes to it by number, name, amount, etc. Account for all missing notes.

(11) Trace each note payable, or at least those comprising the audit balance, into the cash receipts book or other book of original entry, in order to verify that the proceeds were received. Use the information obtained to classify the notes. See section 511.

(12) Trace each cancelled note, or at least the largest ones, into the cash payments book, or other journal, in order to verify that they were actually redeemed.

(13) Verify all partial payments made on the notes against cash payment book or other proper entries.

(14) Review the cash receipts and payments books for evidence of unrecorded notes.

(15) Review the interest expense, and accrued interest payable accounts, etc. for evidence of unrecorded notes.

(16) Secure confirmations from banks and note brokers regarding ALL notes sold by them for the client.

(17) Secure confirmations from banks and others, if there is occasion to write to them about other matters as to the existence of notes or other liabilities. In some cases it may be advisable to write to banks where the deposits and lines of credit have been closed out during the period.
(18) In the case of purchase money (lien) notes, ascertain if all of the notes have been recorded. See that the interest thereon has not been charged to the asset purchased.

(19) Ascertain from the client if he has arranged for any bank to accept drafts against bills-of-lading. If so, record the asset purchased and note liability if the bank has accepted the draft(s). In other instances a balance sheet footnote may be sufficient.

(20) Ascertain what notes, if any, were renewals or were given in settlement of overdue accounts.

(21) Ascertain if any accounts receivable have been pledged against notes payable.

(22) Ascertain the disposition of notes maturing after the audit date, but before leaving the audit.

(23) Classify the notes as: (1) bank loans, (2) trade creditors, (3) directors, stockholders, employees, officers, (4) renewals, (5) sold through brokers, (6) payment of overdue accounts, (7) secured by collateral, (8) loans by affiliates or subsidiaries, (9) trade, affiliates or subsidiaries, (10) purchase money for machinery, equipment, etc., (11) past due, (12) etc., etc.

(24) Get a certificate from J.R. and P.R. Wilson to the effect that all notes of the business, issued by the partners individually, have been taken up in the books of account.

513. Explanation and Comments.—This plate represents the notes payable section of AN audit program. The reader should make a critical study of the procedure outlined therein. Note that the auditors deemed it very desirable to get a certificate on notes payable from the partners. In this connection, it may be said that to ascertain that all outstanding notes payable have been recorded is extremely difficult, in fact impossible, in sole proprietorships, partnerships, and closed corporations, without an audit of the officials as well as of the books and records. A partner, for example, may give a partnership note for a loan devoted to personal ends. Of course, the partner expects to meet the note personally when it comes due; nevertheless, it is a partnership liability.
**ADDENDUM**

Notes Payable Secured by Stocks and Bonds.

**Ordinary Loans.**—Whenever the credit of a customer will not warrant the granting of an unsecured loan, stock and/or bonds may be required as collateral security. The securities which are pledged may be either listed or unlisted stocks and/or bonds. Of course, a bank always prefers listed securities (i.e., those quoted on leading Exchanges, such as the N.Y. Stock Exchange), but often accepts unlisted securities from its best customers.

An unlisted security is not looked upon by a bank with the same favor as a listed security, although the former may actually be a better collateral security. The reason for this attitude lies in the fact that there is great difficulty in ascertaining the day to day value of an unlisted security, and in the fact that there is no steady market for its sale. For these reasons, among others, a bank will generally require a larger margin of safety on unlisted securities than on listed securities. Moreover, it may require the pledger to submit a recent balance sheet of the corporation whose unlisted securities are offered as collateral, and a pledge to advise it (the bank) of any important changes in the corporation's financial status.

From day to day, bank employees keep tabs on the adequacy of the securities. If their market value falls below a certain margin of safety, often 20 per cent, the loan is called in if it is a demand loan, or more security is demanded if it is a time loan.

**Stock Brokers' Loans.**—Only a small amount of loans is made to stock brokers on a time basis. The bulk of the loans is made on demand. As the brokers, to whom these loans are granted, do not have deposit accounts with the bank, it never hesitates to call in a loan whenever it desires.

Although these loans are demand loans and therefore callable at any time, it is the custom in New York to grant at least one day's time. Moreover, loans are not called in after 1:00 p.m., although a bank is legally entitled to do so at any time up to the close of its business hours. The broker must redeem his loan by 2:15 p.m. of the day on which it is called. Of course, a loan may remain outstanding for many days until the broker pays it up, or until the bank calls it in.

The securities which a broker pledges are mainly those which he is carrying on margin for his customers; others may be his own. Securities which are fully paid for by customers, but which are still in the possession of the broker, cannot be pledged.

Besides being listed, the pledged securities must be diversified if the loan is a large one. Obviously, the bank does not intend to be caught in a declining market with "all of its eggs in one basket". There is, of course, no rigid rule as to the nature of the diversification required.

All collateral must be properly indorsed to the bank, or accompanied by a proper power of attorney, so that the bank can sell the securities if need be. The agreement which the broker signs provides that the bank may sell the securities to itself at public auction whenever the margin of safety falls below that required. Of course, before this sale can take place the broker is permitted to repay the loan or furnish additional security.

As stated above, most of the securities pledged with the bank belong to the broker's customers; therefore, in order for the broker to complete his sales he may have to withdraw certain of the pledged securities. If so, the broker must substitute an equal amount of satisfactory collateral.
1. From what source will the auditor prepare his schedule on notes payable?
2. What types of outstanding notes will be verified by direct correspondence? Why these types? What types are not ordinarily verified in this manner?
3. Why does an auditor examine the prepaid interest and the interest expense accounts as a part of his examination of the notes payable account?
4. How might the provisions of a bond issue affect the amount of notes payable?
5. What is the difference between covering the same ground twice, and covering it twice but from two different angles of approach? Make your answer an illustration.
6. A bank has agreed with a client to accept drafts drawn against bills-of-lading. When should the client record the transaction? Why? How?
7. Why are assigned accounts receivable stamped in the name of the lender?
8. What is the difference between covering the same ground twice, and covering it twice but from two different angles of approach? Make your answer an illustration.
9. When should the client record the transaction? Why? How?
10. Draw up a Notes Payable Register and record therein 3 promissory notes, 1 two party draft, 2 three party drafts, 1 trade acceptance, 1 note payable to a bank, and 1 payable to an officer. Indicate all postings.
11. What use, if any, will an auditor make of cancelled notes payable?
12. What further investigation should an auditor make when he finds a chattel mortgage note?
13. What is the auditor's duty when he finds notes payable secured by assigned accounts receivable?
14. Draw up a schedule like Plate 135. Make 10 entries.
15. Give three important reasons why it is necessary to verify the origin of each outstanding note payable.
16. Why is it advisable for the auditor to bring his audit of notes payable—banks up to the day of the actual auditing?
17. Why should the by-laws and directors' minutes be examined in connection with the audit of the notes payable account.
CHAPTER 33

THE VERIFICATION OF ACCOUNTS PAYABLE

514. General Discussion.

516. Explanation of Plate 168.

517. Auditing the Personal Accounts.

518. Explanation of Plate 169.

519. Explanation of Plate 170.

520. Other Verification Procedures.

522. Explanation of Plate 171.

523. Goods Received in Advance for the New Season.

524. Discounts.

525. Consignments.

526. The Balance Sheet Presentation.

527. Explanation of Plate 172.

521. Confirmations.

528. Explanation of Plate 173.

Review Questions.

514. General Discussion.—To the general public, the term accounts payable includes all liabilities not evidenced by something tangible, such as notes, bonds, acceptances, and the like. That is, to state the matter in another way, the term accounts payable is often made synonymous with liabilities due for merchandise, supplies, expenses, taxes, wages, interest, etc. As the reader might surmise from his having studied the proper division of accounts receivable, this category of accounts payable is altogether too inclusive for balance sheet purposes. At most the term is limited to merchandise, supply, and certain expense debts. Strictly used, it applies to debts for merchandise (or raw materials and supplies) only. All other payables must be stated under more suitable captions.

515. Auditing the Controlling Account.—In a detailed audit, the debit and the credit entries in the general ledger account should be tested rather extensively. This is accomplished, of course, through the verification of the purchase book, the cash payments book, etc.

As to credit entries, the auditor must ascertain that all liabilities have been recorded, and in the case of those which are recorded that they were properly incurred, and that the proceeds thereof were received. Likewise, the auditor must satisfy himself that the debit entries were proper and genuine. Obviously, such an examination of the debits and the credits should disclose any fictitious entries which do not come from books of original entry, etc.; or if they do, have no supporting data.

If the auditor determines the source of the entries in the account, he may possibly ascertain important facts. Thus a debit to the account from the Notes Payable Register will suggest that perhaps overdue accounts are being turned into notes instead of being paid. Likewise, a credit from the Cash Receipts Book may turn out to be a loan payable, —not a trade

1In a balance sheet audit, most of the auditor's attention centers around the final balance of the controlling account, chiefly for the purpose of seeing (1) if it is understated and (2) if it can properly be classified as accounts payable. 2Furthermore, in certain cases some of the liabilities may not be liabilities, as when, for example, petty cash reimbursement vouchers (payable to distant Branches) are still among the open items composing the audit balance.
EXPLANATION OF PLATE 168

AN ANALYSIS OF THE ACCOUNTS PAYABLE ACCOUNT

BROADBENT, INC.
Summary of the Accounts Payable Account
Audit for Six Months Ending Dec. 31, 1930

516. Explanation and Comments.—This plate is a summary of the entries in an Accounts Payable controlling account. Such an analysis will often disclose unusual entries; i.e., entries from books of original entry other than the Voucher Register, The Returned Purchases Book and the Cash Payments Book. These special items should be traced back to their source. Thus, in illustration, the results of the analysis showed (1) that many of the company's outstanding notes payable were simply extensions of due or overdue accounts; (2) that a loan payable to J.S. Broadbent was erroneously classified in this category; (3) as was also an advance on a sales contract received from Sears, Roebuck & Howe Co. Of course, these three facts should be disclosed from an analysis of the notes payable, and from a review of the individual account payable balances, but the point is that it is worth the auditor's time to have his audit program overlap at important points.

At this time it may be interjected that some businesses do not have either a voucher or a purchase book, but merely enter and distribute the invoices in the cash payments book at the time they are paid. Therefore, in such instances the unpaid invoices at the audit date will be recorded by a journal entry, which is reversed on the first day of the next period. Of course, it is possible, but not preferable, for the client to omit the entries, in which case the auditor alone will "take up" the adjustment.

EXAMPLE

June 30, 1930

<table>
<thead>
<tr>
<th>Machinery</th>
<th>6,750.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stores</td>
<td>817.12</td>
</tr>
<tr>
<td>Selling Expenses</td>
<td>3,266.54</td>
</tr>
<tr>
<td>Administrative Expenses</td>
<td>1,071.17</td>
</tr>
<tr>
<td>Unaudited Vouchers Payable</td>
<td>11,924.83</td>
</tr>
</tbody>
</table>

July 1, 1930

<table>
<thead>
<tr>
<th>Unaudited Vouchers Payable</th>
<th>11,924.83</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>6,750.00</td>
</tr>
<tr>
<td>Stores</td>
<td>817.12</td>
</tr>
<tr>
<td>Selling Expenses</td>
<td>3,266.54</td>
</tr>
<tr>
<td>Administrative Expenses</td>
<td>1,071.17</td>
</tr>
</tbody>
</table>

1Sometimes these invoices will be distinctively marked so that they will be charged to Unaudited Vouchers Payable when they are paid; in which case no reversal entry is necessary.
AN ANALYSIS OF THE ACCOUNTS PAYABLE ACCOUNT

**Plate 168**

**Broadbent, Inc.**

**Summary of Accounts Payable Account**

**Audit for Six Months Ending Dec. 31, 1930**

<table>
<thead>
<tr>
<th>Book of Original Entry</th>
<th>Description</th>
<th>Contra Accounts Payable Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per G/L and our papers 6/30/30</td>
<td></td>
<td>102681.40</td>
<td></td>
</tr>
<tr>
<td>Voucher Register</td>
<td>Sundry Items</td>
<td>644689.42</td>
<td>644689.42</td>
</tr>
<tr>
<td>Notes Payable Register</td>
<td>Notes Payable(T)</td>
<td>36309.91</td>
<td>36309.91</td>
</tr>
<tr>
<td>Cash Payments Book</td>
<td>Cash on Account</td>
<td>589701.02</td>
<td>589701.02</td>
</tr>
<tr>
<td>Returned Purchase Book</td>
<td>Ret. Purchases</td>
<td>47091.58</td>
<td>47091.58</td>
</tr>
<tr>
<td>Cash Receipts Book</td>
<td>Loan from J.S. Broadbent, Pres.</td>
<td>25000.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Advance on Sales Contract with Sears Roebock &amp; Howe Co.</td>
<td>100000.00</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>673102.51</th>
<th>872370.32</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per books 12/31/30</td>
<td></td>
<td>199268.31</td>
<td></td>
</tr>
<tr>
<td>Adjustment #47 - Dec. 1930 items entered in Jan. 1931</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Final Balance 12/31/30</td>
<td></td>
<td>215952.03</td>
<td></td>
</tr>
</tbody>
</table>

**BALANCE SHEET PRESENTATION**

**Accounts Payable:**

- Not due: 72336.56
- Past due: 18615.47

**Loan Payable - Officer**

- 25000.00

**Advance Receipt on Sales Contract**

- 100000.00

**Total as above**: 215952.03

(T) These are overdue accounts, now in the form of notes, Must be commented on.
To be certain, these important facts should be uncovered from other angles of the audit procedure, but the point is, to repeat, that a competent auditor purposely designs his audit program in such a manner that it will cover important phases of the audit from at least two different angles.

In respect to postings, these may be completely checked in the case of the general ledger controlling account, but a limited test of the entries in the individual personal accounts (if any) is sufficient in ordinary cases where a good system of internal check exists.

516. See Plate 169.

517. Auditing the Personal Accounts.—As just indicated, there may, or may not, be one or more personal ledgers. Whenever an account payable ledger is kept, a few postings should be checked both by the analysis method and the check method of auditing; Likewise, a few accounts should be checked out in complete detail, including footings and balances. During this procedure the auditor should see that these accounts look regular in every way. If one does not, he should call for that creditor's monthly statement. If it is not available, the auditor should ask, and insist if necessary, that the client secure a duplicate one.

Ordinarily it is not necessary to prepare a detailed list of the open accounts (Plate 169), for it is rare indeed for the auditor to present in his report a list of these open balances. The type of schedule generally prepared is suggested by Plate 170.

If a complete voucher register system is used, no personal ledger exists;—the open items in the register constitute the details of the controlling account. In instances of this sort, the auditor's Vouchers Payable schedule may be simply an adding machine tape of the open items. This will be pasted on to regular audit schedule paper as a permanent and concrete evidence that the sum of the open items was in agreement with the balance of the controlling account. An optional method would be for the auditor to merely indicate in the REMARKS column of the Work Sheet that he had proven this fact. This would explain the absence of a schedule letter opposite the vouchers payable balance.

Irrespective of the nature of the bookkeeping records, the auditor must ascertain which are the past due items. If, for example, there is a sizable volume of overdue accounts, these must be mentioned in a statement prepared for credit purposes, internal management, and/or the like. Moreover, the auditor should ascertain the reason for the overdue accounts. It may be that an account has been paid, the debit having been erroneously entered in another creditor's account, etc. Or the account may be in dispute, the correct liability being much larger than that recorded.

The auditor must also determine the origin of each balance if he is to classify them properly. Moreover, unusual transactions are sometimes brought to light in this manner. Thus on one occasion such an analysis showed that a certain account was not payable to a trade debtor but to a finance company for money borrowed against pledged accounts receivable. (A limited audit of the Cash Receipts Book had failed to disclose this transaction because the entry was in a month other than those audited.)

If the detailed balances do not agree with the controlling account, the auditor is often called upon to use considerable judgment in determining what to do about it. He may feel, for example, from his knowledge of the system of internal check, and of the general carefulness of the office force, that the error will be straightened out in the course of the next few days. On the other hand, the general condition of the books, the

---

In a detailed audit, perhaps not more than a month or two; in a balance sheet audit, not more than a few days, or perhaps none at all.
system of internal check, etc. may be such that the auditor does not feel inclined to overlook the matter. In such instances, if the amount is small, the auditor should not assume that the matter is insignificant, because it may be a small NET error, i.e. one consisting of a number of LARGE offsetting errors. If the excess of the details over the control is large, a liability reserve should be set up for at least this amount. If the controlling account is the greater, it should stand as is, until the differences have been located or otherwise adjusted. In either of the two latter cases the discrepancy between the details and the control should be mentioned in the report.

518. See Plate 169.

519. See Plate 170.

520. Other Verification Procedures.—It is common knowledge that a balance sheet of a sizable business is not likely to contain all of the liabilities if it is prepared promptly after the close of the fiscal period. Therefore, the auditor ought to reserve the audit of the Accounts Payable account for one of the last assignments. In making this examination, the auditor should call for all of the creditors' monthly statements. If the client has not kept them, duplicates of the largest accounts must be sent for. Moreover, the client should be instructed to save all statements in the future, and send for those which do not come in. The author has time and again found important omissions by means of this simple but effective check.

In the case of a complete voucher register system, it is often somewhat difficult to check the creditor's statement, since the open items in the Voucher Register are not grouped by name of creditor, as in the case where a personal ledger is used. In such instances the auditor should consider the advisability of suggesting to the client that it keep some sort of an index showing the voucher numbers applicable to each creditor.

Besides auditing the Voucher Register for the last month of the period, the auditor should examine all of the entries which have been made since then, including also an examination of all unrecorded vouchers. The purpose of this procedure is to make certain by an examination of the date of receipt of the goods, etc. that there are no vouchers included therein which properly belong to the period under audit.

Attention is again directed to the necessity for reviewing all unentered vouchers, as well as those which have been entered. This word of caution is doubly important whenever the vouchers are withheld from entry until paid. Under this system there is no Purchase Book or Voucher Register,—the distribution being made in the Cash Payments Book at the time of payment. The unentered vouchers at the audit date are recorded in the Journal as an adjustment entry, a reversal entry being made on the first day of the new period (Plate 168).

The auditor should also check the client's Receiving Record against the Voucher Register for the last few days of the period, and for the first few days of the new period. This examination is advisable even in instances

In his zeal to pick up additional liabilities, the auditor should not forget to be practical. Even the federal income tax law realizes this as follows: "It is recognized, however, that, particularly in a going business of any magnitude, there are certain overlapping items both of income and deduction, and as long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts."—Regulations 74 — (Art.342).
### A Schedule on Accounts Payable Plate 169

**Mowry & Jordan, Inc.**

**Accounts Payable**

**Audit for Year Ending April 30, 1930**

<table>
<thead>
<tr>
<th>Vo. No.</th>
<th>Date</th>
<th>Creditor</th>
<th>Raw Materials</th>
<th>Supplies Etc.</th>
</tr>
</thead>
<tbody>
<tr>
<td>4101</td>
<td>1/12</td>
<td>Brown &amp; Co.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4281</td>
<td>2/12</td>
<td>J &amp; T Powell Co.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4387</td>
<td>3/1</td>
<td>Simpson Bros.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4102</td>
<td>1/13</td>
<td>J &amp; T Powell Co.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4306</td>
<td>2/3</td>
<td>Rudolph Harper &amp; Co.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4409</td>
<td>4/28</td>
<td>Chateau, Inc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4410</td>
<td>4/29</td>
<td>The Atlas Co.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4411</td>
<td>4/29</td>
<td>Hammond &amp; Hammond</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Omissions

<table>
<thead>
<tr>
<th>Vo. No.</th>
<th>Date</th>
<th>Creditor</th>
<th>Raw Materials</th>
<th>Supplies Etc.</th>
</tr>
</thead>
<tbody>
<tr>
<td>4412</td>
<td>4/30</td>
<td>J &amp; T Powell Co.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Balance per General Ledger 4/30/30** 103495.96

**Adjustment #29**

- 4497 4/28 Brown & Co. Rec'd 4/30 as per Receiving Record, page 718. Included in inventory on page 16 - Raw Material 20847.89
- 4499 5/30 Harvey & Roach (April advertising in The Daily Globe) 950.00 21807.59

**Adjusted balance April 30, 1930** 125303.55

To B/S

**Audit Procedure**

See AA-3 for goods - in - transit

Audited the V. Register for April and up through May 21, 1930

Checked the above to the creditors' monthly statements. O.K.

Checked the Receiving Record to the Voucher Register for last 2 weeks of April, and up thru May 21st for goods - in transit. See AA-3

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**518. Explanation and Comments.**—Whenever the number of outstanding creditors is very few, a detailed schedule such as this one might be prepared. Ordinarily, however, a mere adding machine tape of the open balances would be sufficient, the tape being pasted on to the work sheet as complete evidence that the details are in agreement with the controlling account. Another method of taking care of the situation would be to make a few comments in the REMARKS section of the Audit Program.

It is always advisable to show the dates of the overdue accounts, and the amounts of special or large accounts, so that these may be commented upon in the report, and, if necessary, separated on the balance sheet.
A SCHEDULE ON ACCOUNTS PAYABLE PLATE 170

Reed & Bartone, Inc.
Accounts Payable
Audit for Year Ending Dec. 31, 1929

<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>A REGULAR</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Not due</td>
<td></td>
<td>47687.92</td>
</tr>
<tr>
<td>Past due</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Barber Colemane  8/6/29</td>
<td>1416.89</td>
<td></td>
</tr>
<tr>
<td>Rockford &amp; Rockford 10/1/29</td>
<td>387.15</td>
<td></td>
</tr>
<tr>
<td></td>
<td>9/3/29</td>
<td>6143.97</td>
</tr>
<tr>
<td></td>
<td>9/7/29</td>
<td>971.47</td>
</tr>
<tr>
<td>Tucker Inc</td>
<td>1283.40</td>
<td>28496.57</td>
</tr>
<tr>
<td>OMISSIONS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HARPER COMPANY Advances on Purchases</td>
<td>16389.00</td>
<td></td>
</tr>
<tr>
<td>STONE &amp; HARVEY Returned Purchases</td>
<td>4689.42</td>
<td></td>
</tr>
<tr>
<td>B AFFILIATED COMPANY</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reed, Schneider &amp; Hawkins (past due)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>21078.42</td>
<td>142147.90</td>
</tr>
<tr>
<td></td>
<td></td>
<td>21078.42</td>
</tr>
<tr>
<td>Balance per books 12/31/29</td>
<td>121069.48</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>1501.81</td>
</tr>
<tr>
<td>ADJ.</td>
<td>12/29/29 Boucher, Inc. Supplies rec'd in Dec. Vo. #1-15</td>
<td>154090.94</td>
</tr>
<tr>
<td></td>
<td>12/30/29 Williams Coal Co. Supplies and coal rec'd in Dec. Vo. #1-1 2600.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Adjusted Balance 12/31/29</td>
<td>125171.29</td>
</tr>
</tbody>
</table>

BALANCE SHEET PRESENTATION

Accounts Payable - Trade:
|                   |          |          |
| Not due           | 51789.73 |          |
| Past due (Affiliated 65963.41) | 94459.98 | 146249.71|
| Customers' Credit Balances ADJ. A-1 | 7841.23 (C) 154090.94 To B/S |
| Advances on Raw Materials Purchases | 16389.00 To K |
| Creditors' Debit Balances ADJ. A-8 | 4689.42 To D Same as above 21078.42R |

See the Audit Program for the audit procedure.

519. Explanation and Comments.—It is believed that a study of this schedule will reveal to the junior auditor several interesting points. The accounts are classified under two main headings; namely, REGULAR and AFFILIATED COMPANY. These in turn have been divided into past due, and not due. Note the treatment given to the debit balances. This adjustment has been given an auditor's adjustment number; i.e. number A-8. Such a designation means that the adjustment is not to be taken up on the books. It is simply an adjustment made for the auditor's own convenience in getting into the Balance Sheet columns of his Work Sheet all of the accounts for a proper balance sheet presentation.
where the invoices show the dates on which the goods were received. It has often disclosed goods received and inventoried but not entered in the register, either because of a slip up, or because no voucher was received from the creditor. Likewise, suppressions of goods (and their invoices) received on the last day or two may be detected. Sound practice, of course, requires the inclusion of these goods in the inventory and the vouchers in the trade payables.

Comparative tests should be made of the various expense accounts. For example, if a current expense account is decidedly out of line with the amount at the same date last year, the reason for it should be ascertained. The investigation will seldom show any errors; but when it does reveal errors, they are usually worth while correcting. Of course, even if no error is found, the investigation must not be looked upon as time wasted.

In conclusion, it should be pointed out that the auditor does not attempt to take up every possible adjustment,—only the significant ones are brought on to the books. However, such a policy should not be allowed to be construed by the client's Voucher Register clerk as a justification for her adoption of the same policy. For her the rule is that no amount is too small to be bothered with. Such insistency on the part of the auditor will prevent this clerk from gradually becoming less and less critical about holding open the Register until the latest possible moment.

Whenever the auditor knows that he has omitted insignificant liabilities, he must not state in his certificate that "all known liabilities have been taken up on the books." But this does NOT mean that he is prevented from giving an unqualified certificate.

521. Confirmations.—It is very unusual to circularize creditors (Plate 171), their monthly statements being accepted in lieu thereof. If, however, an account is very large in proportion to the total trade payables, or if an account is due to an affiliated business, or if the creditor holds some collateral, or if the payables are large and few in number, they should be circularized.

On unusual audits, such as where there are no books of account, or where the audit is being made for a bank having suspicions, the auditor may deem it very essential to circularize every creditor with whom the client has done business for at least a year back. In such instances it is often surprising to see how many unrecorded liabilities will come to light. The client may object to the procedure on the ground that it invites an unscrupulous creditor to present a fictitious claim, or a claim for a bill of goods already paid for. As there is no basis for this contention, whatever, the auditor must not give it any attention.

522. See Plate 171.

523. Goods Received in Advance for the New Season.—In certain types of businesses, such as, for illustration, the wholesale dry goods business, it is customary for the buyer to order and receive the next season's goods before the close of the preceding season. However, the invoices are generally postdated several months. Thus it comes about that at inventory time a client may have on hand a large inventory, even though it is really the end of his true business year.

Some auditors believe that since it is a well established custom for the buyer to omit recording these goods until the beginning of the new year, the auditor, in case of suit, to a literal interpretation of his certificate.

This statement is too exact for the situation assumed. A court of law would undoubtedly hold the auditor, in case of suit, to a literal interpretation of his certificate.
Dear Sirs:

Please fill in and forward to our auditors the attached CERTIFICATE in the addressed and stamped envelope enclosed herein.

Yours truly,
[Name of Client]

Messrs. Jacobson, Levy & Co., 701 Roosevelt Building, Johnson City, N.Y.

Gentlemen:

We are pleased to furnish you the following information as requested by our customer [Name of Client].

Yours truly,
[Name of Creditor]

Due on Notes and Other Liabilities
Open Account Trade Acceptances or Collateral

Due Amount Date Time Rate Amount

522. Explanation and Comments.—It is very unusual to circularize creditors, their monthly statements being accepted in lieu thereof. If, however, an account is very large in proportion to the total trade payables, or if an account is due to an affiliated business, or if the creditor holds some collateral, etc., it should be circularized.

On unusual audits, such as where there are no books of account, or, if any, they are known to be poorly kept, the auditor may deem it very essential to circularize every creditor with whom the client has done business for at least a year back.
season, the auditor should simply mention the fact in a footnote. However, the best practice by far is to include these goods in the inventory and the vouchers in the trade payables. On the whole it also seems advisable to separate these items from the other inventories and payables by proper explanatory captions. In no case is an omission of the facts justified; and a mere note that there are such goods on hand without any statement as to their amount, etc., is hardly the work of a competent auditor.

The above position is taken by the writer because even a full footnote does not create a favorable impression upon an experienced balance sheet reader. More specifically, the goods are on hand and the liability is real.

624. Discounts.—Trade discounts should always be deducted from the gross amount before the bill is entered in the voucher register. If, however, a trade discount is to be allowed only if the client finally buys during the year a stated amount of goods, the invoices must be entered gross. Whether or not an adjusting entry (debiting, Trade Discounts Receivable and crediting, Purchases) is advisable at the audit date would, in the writer’s opinion, depend upon the particular facts of each case. That is to say that no dictum can be laid down on this matter. This is an instance where the auditor’s professional opinion is in order. Thus if $300,000 worth of goods out of a $1,000,000 worth has been purchased by December 31 with the final date still four months in the future (i.e. April), the auditor should set up an adjusting entry for a proportional amount of the total trade discount, if in his opinion there is no reason to suppose that the quota will not be easily surpassed by April. As just stated, if an auditor is not to be allowed (or is not willing) to express a professional opinion under such circumstances, he might just as well be an automaton.

Ordinary cash discounts, such as 2% ten days, are sometimes deducted before the bill is entered. In such instances the auditor is not called upon to see if all of the open discounts at the audit were eventually taken, for the amount is too trivial. However, the auditor should see that the client is also allowing for possible sales discounts yet to be taken by customers.

If the client, having entered the purchases gross, desires to make provision for the cash discounts yet to be taken (the auditor would not ordinarily suggest it), or if there are special reasons why the auditor feels that the provision should be taken up on a particular audit, he can readily ascertain the proper amount by analyzing the discount column in the cash payments book for the first part of the next period.

525. Consignments.—Whenever the client is a consignee, the auditor should always have in mind the strong possibility of the client’s having unrecorded liabilities in connection therewith. First of all the auditor should investigate the client’s accounting methods for handling consignments. It may be, for example, that the Sales account is credited (rather than the “Due to Consignor” account) when consigned goods are sold. If so, an adjustment is obviously in order. Following this investigation, the auditor should make certain that an inventory of the consigned goods was taken as at the audit date. Each consignor’s goods must then be verified by direct correspondence with the consignor. If this procedure reveals that a consignment has been partly sold, the liability, commission earned, etc. thereon must be taken up. Whether or not the total of the “Due to Consignor” accounts is a current liability depends, of course, upon how soon the accounts are to be settled.

1A valuation account offsetting Accounts Payable.
2Such inventories are NOT, of course, a part of the client’s inventories.
The Balance Sheet Presentation—In drawing up a balance sheet, the secured liabilities must always be distinctly separated from the unsecured liabilities. Likewise, those debts payable to the trade must be separated from those due to stockholders, officers, employees, etc. Furthermore, if the balance sheet is to be used for credit purposes, or for internal management purposes, the amount due to affiliated companies, and the past due accounts must also be indicated.

In taking off a list of the open balances (or items), the auditor may run across some debits. These items must be analyzed. If they represent amounts due from creditors, they may be set up as current assets under some such caption as, Creditors' Debit Balances. If the amount represents an advance payment by the client, the item may be designated as Advances on Purchase Orders, a current asset in the inventory group. If the account is with one who buys from and sells to the client, the debit balance should be added to the regular accounts receivable-trade.

Likewise, as noted hereinbefore, Customers' Credit balances may be included hereunder if small or shown separately as such, provided always that they are in the nature of accounts payable. Customers' credits arising from advance receipts against future sales, for example, must NOT be included. They are "Advances on Sales Orders". Such an account should be listed as a deferred income item, or, in some cases shown as a deduction from the inventories.

The reader's attention is again directed to the liability section of the balance sheet of the Federal Reserve Board (Plate 152).

It should be obvious that "if current liabilities are small in amount as compared to current assets, but are (all either long overdue, or) all due in the near future, whereas most of the current assets, as accounts and notes, cannot be collected until some time later, a serious situation may exist even though a very fair condition may be shown by omitting the necessary information as to liability maturity dates and asset realization dates."—Bennett (p.187).
THE ACCOUNTS PAYABLE SECTION OF AN AUDIT PROGRAM

**ALLEN & CRAWDEN**

**Audit Program**

B/S Audit for Six Months Ending Dec. 31, 1929

<table>
<thead>
<tr>
<th>Date-By Whom</th>
<th>Date-By Whom</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31, 1929</td>
<td>June 31, 1930</td>
</tr>
</tbody>
</table>

(16) **Vouchers Payable and Voucher Register**

1. Vouch for the 6 months all amounts over $500; and for July and Dec. all vouchers.
2. Vouch all June 1929 and Jan. 1930 entries over $50.
3. Check all July and Dec. postings to the G/L.
4. Check to the General Ledger any of these items which are in the MISCELLANEOUS column of the Register.
6. Check all June and Dec. creditors' statements against the balances shown in the various personal accounts.
7. Take off a tape of the open accounts as at 12/31/29, and prove with controlling account. Eliminate all open items which are due to branches. Show separately those due to affiliates and/or subsidiaries.
8. Review with the Voucher Register clerk the names of those creditors making up the final balance, endeavoring to weed out items not true Vouchers payable as defined in #26. It is preferable for the auditor to see the vouchers themselves.
9. Compare the Returned Purchases Record for June and Dec. against the debits to creditors.
10. Ascertain which accounts are overdue. Age them.
11. The balance owing to each creditor should be supported by specific unpaid vouchers. If not, ascertain why. It may be that the odd amount is only part of a greater liability that should be recorded.
12. Ascertain that all liability on consigned goods sold BY the client has been taken up.
13. Ascertain that all liability (for expenses, commissions) on consigned goods sold FOR the client has been taken up.
14. Compute as usual the Provision for Cash Discounts. Also, are any quantity rebates to be taken soon?
15. Take up all goods-in-transit at Dec. 31 unless F.O.B. destination.
24. Correlate the Check Register with the Voucher Register for June and Dec.

25. Review the Check Register for July 1-15, 1929 and Jan. 1-15, 1930 for overlapping expenses, etc.

26. Limit the term, "Vouchers Payable" to debts incurred for raw materials and supplies.

27. Confirm by letter the balance due to Allen, Barber & Chadsey, Inc.

28. Review the general ledger account for unusual entries, such as debits from the Notes Payable Register and/or credits from the Cash Receipts Book, etc., etc.

29. Inquire into all accounts long overdue. Verify by correspondence.

30. Ascertain the usual discount terms.

31. Ascertain the amount of neglected discounts.

32. Review the unentered vouchers for items belonging to the period under audit.

33. Review the purchasing agent’s record of orders placed and executed.

34. Secure a Certificate on Liabilities from the client in the same form as usual.

527. Explanation and Comments.—This plate is the account payable section of an audit program. Note that the balance due to Allen, Barber, and Chadsey, an affiliated company, was verified by direct correspondence. Also note item 14. As explained in the text, it is unusual to set up a Provision for Cash (Purchase) Discounts.

Even when a Voucher Register is used, the necessity of reviewing the Cash Disbursements book for the period following the audit (for vouchers applicable to the audit period) is called to the reader’s attention. Few businesses maintain a strict voucher register system whereby ALL payments must be supported by a voucher which must be passed through the Register first.
REVIEW QUESTIONS

1. How should known trade discounts be handled?
2. Of what value is it to determine the origin of each open account payable?
3. Why should the audit of the Accounts Payable account be postponed as one of the last assignments?
4. Of what value to the auditor are the creditors' monthly statements?
5. Why is an accounts payable index helpful when a complete voucher system is used?
6. What is the method for recording vouchers when there is no Purchase Book or Voucher Register?
7. If the vouchers show the dates on which the goods or services were received, is it necessary to make use of the Receiving Record? Elaborate your answer.
8. Under what different classifications might accounts payable appear?
9. How should debit balances of accounts payable be treated? Why?
10. What is meant by the term Accounts Payable-Trade?
11. How would you investigate consignments received?
12. A client will get a trade discount if it purchases during a certain period a stated volume of goods. How would you handle the matter at the audit date?
13. What does a schedule on accounts payable look like? Prepare one as your answer.
14. Must the auditor take up every possible adjustment? Give reasons for your decision.
15. How would you determine the proper amount of the allowance for Cash (Purchase) Discounts account as at the audit date? Assume that you arrive on the audit a month later than the audit date.
16. Why should the Accounts Payable controlling account be analyzed? How?
17. When would you circularize the accounts payable?
18. To what extent should the entries in the personal ledgers be audited?
19. Suppose that the details of the personal ledger do not agree with the controlling account. What would you do about it?
20. How should cash discounts on purchases be handled?
21. How should an auditor instruct a new client who does not preserve his creditors' monthly statements?
THE VERIFICATION OF OTHER CURRENT LIABILITIES

528. General. 529. Interest.
530. Taxes.
531. Explanation of Plate 173.
PLATE 173 - A Schedule on Local Taxes Payable (1st type).
532. Explanation of Plate 174.
PLATE 174 - A Schedule on Local Taxes Payable (2d type).
533. Explanation of Plate 175.
PLATE 175 - A Schedule on Federal Taxes Payable.
534. Judgments.
535. Employees' Profit Sharing Systems.
536. Commissions.
537. Freight.
538. Wages, Salaries, Etc.
539. Explanation of Plate 176.
PLATE 176 - A Schedule on Accrued Wages, Salaries, Etc.
540. Employees' Liability Insurance.
541. Explanation of Plate 177.
PLATE 177 - A Schedule on Employees' Liability Insurance.
542. Unclaimed Wages.
543. Matured Interest Payable Covered by Deposits.
544. Dividends Payable.
545. Audit Fees.
546. Foreign Purchases.
547. Legal Fees.
548. Contractors' Accounts.
549. Guarantees.
550. Sundry Expenses.
550a. Audit Program.

Review Questions.

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528. General.—In this chapter many common current liabilities, other than those already dealt with, are to be considered. Specifically, this discussion will include interest, taxes, wages, judgments, deposits, insurance, rent, customers' credit balances, legal expenses, pensions, commissions, etcetera.

529. Interest.—In determining the amount of accrued interest payable, the auditor must refer to the balance sheet accounts for the principal amounts and to the interest expense accounts and/or the prepaid interest account for information as to the rate of interest and the date to which interest has already been paid. Those sources of information should be supplemented by reference to memorandum records. Thus unsecured notes payable to banks are generally discounted; i.e. the interest is paid in advance. Therefore, there is no accrued interest payable on these liabilities but rather prepaid interest. On the other hand, most of the other types of notes payable will have interest payable accrued on them.

As interest on accounts payable is very easy to overlook, the auditor should immediately make a note on the audit program covering this point.

Interest on overdue taxes, judgments, etc. is common and often sizable; therefore, it must not be forgotten.

530. Taxes.—Federal income taxes are a liability of the period in which the profit was earned. Moreover, it is a true current liability and not a surplus reserve. If the amount is estimated, the caption, Provision for Federal Income Taxes, is preferable to the caption, Reserve for Federal Income Taxes, is preferable to the caption, Reserve for

It is important for the auditor to remember to include in his confirmation letters on obligations outstanding, an inquiry as to the date to which the interest has been paid.
Federal Income Taxes, because many composers of condensed balance sheets group all accounts having the word reserve in their title under one heading, RESERVES. As valuation, liability, and surplus accounts are thus erroneously included under one heading, the balance sheet is worthless, and may even be so intended in fact.

From what has been stated, it should be clear that if the client will not permit an entry for the current tax liability, the auditor will be obliged to make a footnote of it on the balance sheet.

As there is always considerable possibility of there being additional assessments, the auditor, in a first audit, should review the prior tax returns as far back as it is necessary in his opinion. Just what adjustment or notation, if any, will be required will depend upon the individual case. On the other hand, if the auditor is not permitted to review these tax returns, he should qualify his certificate in this respect.

If the Treasury Department has proposed the assessment of additional taxes, and the client is going to defend its position, the auditor is not required to do more than refer definitely to the matter, and the amount, in a balance sheet footnote and/or comment in the report.

"Chairman Montgomery: Assuming that the report of audit shows United Stated income taxes for prior years which have not been finally closed. To what extent do credit grantors consider that the auditor should show on certified balance sheets the exact status of the alleged deficiencies?

"Mr. Young of the National City Bank, N.Y.: Bankers are not tax experts, and are inclined to rely upon the accountants to determine the probable tax liability and to show it in such a way that the financial statement reflects the true condition of the business. It is assumed that before a reputable accountant certifies to a statement he has satisfied himself that the reserve set up for taxes is adequate, and if any taxes are in dispute the banker certainly expects that fact to be clearly shown on the balance sheet.

"The question mentions five different instances, or stages, in a tax assessment, which might arise. The first is where an additional assessment has been proposed in the report of the revenue agent and has been protested. The second case where it has been proposed in the first letter from the Unit and has been protested. Third, assorted in sixty-day letter from Unit and appealed to the Board of Tax Appeals. Fourth, where it is confirmed by the Board of Tax Appeals and appealed to the Circuit Court of Appeals by the taxpayer, and the last is where it is denied by the Board of Tax Appeals and is appealed to the Circuit Court of Appeals by the Commissioner.

"When as assessment for additional taxes is in any of the five stages mentioned, the accountant and tax expert are best qualified by their experience and their familiarity with the precedents of decided cases to judge as to the probable extent of liability involved. If the assessment is merely proposed, or is proposed in the first letter, perhaps a notation of the contingent liability without giving any amount might be sufficient, while if the assessment has been asserted or confirmed by the Board of Tax Appeals, the contingent liability with the amount might be given. If the protest has been denied by the Board of Tax Appeals and been further appealed to the Circuit Court of Appeals, however, the liability has become sufficiently definite to warrant setting it up in the balance sheet accompanied by the proper explanation.

1Current Liabilities - $136,791.74; Notes Payable - Bank (for new properties) - $100,000.00; Mortgages Payable - $69,000.00; Reserves: State and Local Taxes - $17,010.23, Federal Income Tax - 1932- $112,089.08, Foreign Exchange Fluctuations - $32,232.03"--Affiliated Products, Inc. -1932.
“Occasionally, the reverse case will arise, where the concern has made a claim for refund of taxes that may represent a contingent asset. But, as I told you at the beginning, the bankers do not pretend to be tax experts. Most accountants are tax experts, or else they work with tax experts. You may have more definite rules as to just where you would draw the dividing line between those five cases.

“If it were a small amount, it would not make a great deal of difference. But, it it is a very substantial amount, of course it does require careful study. I think the main thing is for you to use your own discretion and if the taxes are not cleared up, set the lender on notice to that effect.”

In regard to property taxes, the auditor should first of all ascertain the period to which the tax applies, and then ascertain the proper current accrual; using as a basis the amount of the tax for the preceding period. Obviously, any change in the tax rate, or in the assessed value of the property, will also have to be taken into consideration in estimating the current tax liability.

531. See Plate 173.

532. See Plate 174.

533. See Plate 175.

534. Judgments.—It should be obvious that unsettled or unpaid judgments may never appear on the client’s books of account. Therefore, if the auditor is to become aware of these actual and/or contingent liabilities, he will have to do his own private investigating. For those auditors who are legally trained, the public records should be examined. For others, a certificate on this point signed by the client and its attorney (if any) is sufficient.

535. Employees’ Profit Sharing Systems.—If the exact liability under an employees’ profit sharing plan cannot be determined and/or is not voted by the directors until a much later date than the close of the period under audit, it is, nevertheless, a true liability of the period which earned the profits. Therefore, an estimated liability provision must be set up. It is not an optional payment like most pension plans.

536. Commissions.—Whenever the client has traveling salesmen, etc., the auditor should realize that he must ascertain if provision has been made for all accrued commissions and expenses payable. As the sales have been made and recorded as income, the salesmen’s expenses thereon are a proper current charge. It is incorrect to take them up in the period in which they are paid.

In this connection the auditor must also be certain that the liability to the salesmen has not already been discharged in whole or in part by advances. If so, the advances are not prepaid assets, but reductions of liabilities.

537. Freight.—If the client sells some of its goods F.O.B. destination, freight to be paid by the buyer and deducted from the bill, the auditor must see that provision has been made for the freight on all such shipments not yet settled. The proper entry at the time of shipment would be a charge to “Freight on Sales” and credit to “Freight on F.O.B. Destination Sales”. If, however, the freight can not be exactly determined at this time, a client will often not make an entry for the freight until the

1 Relations Between Accountants and Bankers”, N.Y.S.S. of C.P.A., Nov.1931, (p.47). “Sometimes, however, there is a prepayment.”
A SCHEDULE ON LOCAL TAXES PAYABLE (1st type)  

BARLUM & TOWER, INC. 

Accrued Taxes (local) Payable  
Audit for Year Ended Dec. 31, 1930  
Schedule FF9  

Provision for Local Taxes Payable  

57900.00  
(To FF)

Per 1929 Tax Receipts

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate</td>
<td>16566.43</td>
</tr>
<tr>
<td>Personal</td>
<td>41049.58</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>57618.01</strong></td>
</tr>
</tbody>
</table>

Audit Procedure

Based on the 1929 tax receipts shown above the estimated liability was set at 57,900.00. The attached letter (FFga) from the Board of Assessors states that there is not going to be any change in the tax rate or the assessed valuation for 1930.

The taxes are assessed here in Cranston in August for the current year. The amount becomes due on January 15th, after which there is a penalty of 1% per month for each month's delinquency in payment.

531. Explanation and Comments.-- In setting up the current provision for local taxes, it is sufficient to use the figure for last year, provided it is adjusted for any known change in the tax rate, the assessed valuation, etc.
**Provision for Local Taxes Payable**

- **Audit for Year Ended Dec. 31, 1930**

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1</td>
<td>Balance per General Ledger and P.R. &amp; Co.</td>
<td>45687.14</td>
</tr>
<tr>
<td>Feb. 28</td>
<td>Taxes paid for the last half of 1929</td>
<td>45687.14</td>
</tr>
<tr>
<td>Jan.-Nov. 11 accruals at estimate of $8000.00 per month</td>
<td>88000.00</td>
<td></td>
</tr>
<tr>
<td>Sept. 1</td>
<td>Taxes paid for first half of 1930</td>
<td>49162.35</td>
</tr>
<tr>
<td>Dec. 31</td>
<td>(Accrued to balance the account at (1/2 of $98324.69 (1930 tax)) (See schedule N-1 for explanation)</td>
<td>10324.69</td>
</tr>
</tbody>
</table>

**Totals**

<table>
<thead>
<tr>
<th></th>
<th>94649.49</th>
<th>144011.83</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>94649.49</td>
<td>49162.34</td>
</tr>
</tbody>
</table>

**Balance per 3/L 12/31/30**

**(To B/S)**

---

**Explanation and Comments.---** Whenever monthly statements are prepared, it is quite common to accrue the tax at a round figure and balance it up to the true total figure for the year, if known, through the last month's entry (here Dec. - $10,324.69).
CARR & CARR, INC.
Provision for 1923 Federal Taxes
December 31, 1923

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provision for 1923 Federal Taxes</td>
<td>208000.00</td>
</tr>
<tr>
<td>(To B/S)</td>
<td></td>
</tr>
<tr>
<td>Net Profit per our P&amp;L Statement</td>
<td>1447967.82</td>
</tr>
<tr>
<td>Add - Nondeductible expenses</td>
<td></td>
</tr>
<tr>
<td>Federal Tax - 1923</td>
<td>207100.00</td>
</tr>
<tr>
<td>Donations</td>
<td>4010.00</td>
</tr>
<tr>
<td>Insurance on Life of Officers</td>
<td>2011.12</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>213121.12</strong></td>
</tr>
<tr>
<td>Deduct - Nontaxable income</td>
<td></td>
</tr>
<tr>
<td>Interest on Mass. State Bonds</td>
<td>5000.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1656088.94</strong></td>
</tr>
<tr>
<td>Federal Tax at 12 1/2%</td>
<td></td>
</tr>
<tr>
<td>Federal Tax Payable 12/31/23</td>
<td>207011.12</td>
</tr>
</tbody>
</table>

533. **Explanation and Comments.** — The current provision for federal taxes is a true current liability. Moreover, from a business point of view the offsetting debit is an expense rather than a distribution of income.
account is settled and the creditor has presented the freight bill in substantiation of his deduction. Therefore, in such cases there is need of the above adjustment at the audit date. The latter is not a liability, however, but a contra valuation account to Accounts Receivable.

538. Wages, Salaries, Etc.—As the fiscal period rarely ever coincides with the date to which all wages and salaries have been paid, there is practically always an accrued liability for wages, salaries, etc. at every audit date.

If there is little variation in the amount of the daily payrolls, it is sufficiently accurate for the client to accrue this liability by proportional methods rather than by exact computations. Thus, if the average daily payroll is $24,000, the accrual for Monday to Thursday inclusive would be $96,000. If the books are not closed promptly, the basis of computation of the average payroll should be the payroll for the actual week under consideration, otherwise the payroll for the preceding week is usually sufficiently accurate. Of course, exact computations are always preferable to proportional computations and in many instances are the only ones acceptable to the auditor. In this connection it should be emphasized that the accrual of salaries must not be forgotten.

539. See Plate 176.

540. Employees’ Liability Insurance.—The premium on employees’ liability insurance is generally based on the amount of the various (hazard) classifications of the payroll. Although some of the premium is often paid in advance, the correct amount is not finally determined until the exact payrolls for the period are definitely known. It often happens, therefore, that based upon the actual payrolls for the period under audit, there exists an additional liability for this insurance.

541. See Plate 177.

542. Unclaimed Wages.—The liability for unclaimed wages is naturally small; hence, on a balance sheet audit little or no investigation is sufficient. In a detailed audit, however, the item becomes part of a much larger problem, namely to investigate the integrity of the payrolls. On such audits a full inquiry into the payroll system, etc. is in order.

543. Matured Interest Payable Covered by Deposits.—Very often bond coupons are paid through the trustee for the bondholders. That is, the debtor corporation deposits cash with the trustee just before the interest date for the total interest payable. The trustee, of course, eventually presents the cancelled coupons to the corporation as evidence of its charges to the deposit account.

When the deposit is lodged with the bank, a common entry for the accountant to make is to charge bond interest expense and credit cash. Obviously, the unclaimed balance of the deposit account and the related outstanding liability on unpresented coupons is not shown on the corporation’s books. The best practice, therefore, is to charge Bond Trustee-Cash and credit Cash so that the deposit and the coupon liability accounts will be recorded on the corporation’s book, and thus remain open to the extent of the uncollected coupons.
A SCHEDULE ON ACCRUED WAGES, SALARIES, ETC. PLATE 176

<table>
<thead>
<tr>
<th>Payroll for week ended Saturday Jan. 3 and payable Jan. 7 = $189,604.59.</th>
</tr>
</thead>
<tbody>
<tr>
<td>$189,604.59 \times 3 (M.T.W.) = $103,420.69</td>
</tr>
<tr>
<td>5 1/2 (days)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>T.B. Clarkson 50000 (Dec.) Salary</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
</tr>
<tr>
<td>4166.66</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>R.M. Clarkson 35000 (Dec.) &quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
</tr>
<tr>
<td>2916.66</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>R.C. Coleburne 12000 (Dec.) &quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
</tr>
<tr>
<td>1000.00</td>
</tr>
</tbody>
</table>

(Last year $119683.24)

| Total | 111504.01 |

Audit Procedure
See Audit Program

539. Explanation and Comments.— Whenever the average daily payroll is fairly stable, the accrued wages payable at the balance sheet date may be computed on average computations. Thus in the illustration the outstanding liability is estimated at 3 times the average daily payroll for the week ending January 3.

Note that the final estimate is set up in a round amount.
When the daily payrolls fluctuate widely, computations by "average methods" MUST NOT be used.
The abbreviation "Etc." should not be used like it is in the above title, for it may be a weasel word; i.e. it may cover a multitude of "sins". Whenever the title would be too long to enumerate the items composing the dollar amount, the abbreviation "etc." should be omitted, IF the omitted items are of the same category as those given.
"(1931) Plant, Property, Rights, Franchises, etc. $1,102,356,468.84
(1932) Plant, Property, Rights, Franchises, etc. (including Discount and Expense on Capital Stock)$1,056,852,941.73"—Standard Gas and Electric Company
Washington, Brafford & Hamilton  
Provision for Insurance Payable  
B/S Audit for Year Ended Dec. 31, 1930  
Schedule BB-5

<table>
<thead>
<tr>
<th>Classification</th>
<th>Payroll Jan.1 to Dec.31</th>
<th>Rate Per $100</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>A, K, G</td>
<td>16840.22</td>
<td>.9680</td>
<td></td>
</tr>
<tr>
<td>B, C, D, E, F, H, I, J</td>
<td>489768.45</td>
<td>1.9117</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>9588.94</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Paid A.I.Co. Jan.1 on Policy #7181324B  
Adjustment #19 - - - Balance Payable 12/31/30  
To B/S 8900.00  
628.94

AUDIT PROCEDURE
The above computations, prepared for us by the Company, were checked by us to the payrolls, policy rates, etc., and found to be correct, resulting in ADJ.#19.

541. Explanations and Comments.-- It is quite common to find that the final premium on workmen's compensation insurance exceeds the advance premium; therefore, the auditor should compute this liability as at the audit date. Sometimes, of course, there is a prepaid amount to be set up as prepaid insurance. As shown by the schedule, the insurance rate per $100 of payroll depends upon the type of risk. Thus the rate for insuring an office clerk is less than the rate for insuring a factory employee.

When the date of the policy is other than that of the Company's fiscal year, it is usually good procedure to show the entire year's payroll as well as the amount from the date of the policy to the end of the fiscal year, the latter being the sum on which the expired portion of the current policy is computed.

In some instances the insurance is carried in whole or in part by the Company itself; thus the American Ice Company's 1932 balance sheet states:

" Investments for Insurance Fund Deposited with State and Federal Authorities:
$84000 United States 4th Liberty Loan Bonds  
$168000 Corporate Stock of City of New York  
$84558.94  
167069.34"

" Reserve for Payments under Workmen's Compensation Act and for Possible Losses Due to Fire and Accident ....... $500000 "

(Note: This reserve of $500000 is added in with the liabilities and captioned;--
" Total Liabilities and Reserve ....... $7,949,193.95").
544. Dividends Payable—When dividends have been declared, the usual entry is to debit earned Surplus and credit Dividends Payable. The latter account then becomes a full fledged current liability if the dividend has been legally declared. The auditor’s duty is to verify the declaration in the Directors’ Minutes and compute the amount on the outstanding stock at the date named and at the rate specified. Furthermore, he must satisfy himself as to its legality.

Some corporations pay the dividend themselves direct to the stockholders and some corporations deposit the cash with a trustee who disburses it for them. When the deposit is lodged with the bank, Dividends Payable could be debited and Cash credited. The better entry, however, is to debit Trustee-Dividend Cash and credit Cash. If this is done, the two accounts will be open to the extent of the checks which have not been cashed by the stockholders. To verify these open amounts, the auditor has merely to get a certificate thereon from the trustee. In conclusion, it may be pointed out that it has been settled at law that if a corporation were to go bankrupt, etc. before a legal deposit has been disbursed, the fund is NOT a general unpledged asset. It is the sole property of the particular stockholders for whom it was originally intended.

Preferred dividends must not be accrued or accumulated, but it may be desirable to segregate the surplus in order to show the portion thereof applicable to cumulative preferred dividends in arrears. Ordinarily, however, the better practice is to state in a note on the balance sheet that these dividends have not been declared since a certain date, and amount to so much as at the balance sheet date. Obviously, this is important information for present creditors, common and preferred stockholders, and for prospective creditors and stockholders.

In the case of a close corporation, it is common to find that a dividend has been paid without its having been formally authorized in the directors’ minutes. Ordinarily the result is not disastrous to the directors, but serious litigation, if not financial loss, would likely arise if the creditors (assuming now that the corporation becomes bankrupt, etc.) should learn of it. Therefore, the auditor should call attention to the omission in his report, if the matter has not been corrected before he leaves the engagement. Finally, when such laxity exists, the auditor should remember to inquire if it is the directors’ intention to pay a dividend based upon the stockholders of record as at a date prior to the audit date. If so, the amount must be taken up at once as a current liability.

545. Audit Fees.—Generally speaking, it is unusual for an auditor to include his bill (or an estimate thereof) as a liability as at the audit date, although, theoretically, it should be included as it applies to the period under review. On occasions, however, such as where a partnership is being audited to ascertain the equity of a retiring partner, the estimated cost of the audit must be treated as an expense to be shared by all.

546. Foreign Purchases.—At the time of the receipt of an invoice payable in foreign money, it is necessary to convert the foreign cost thereof into dollars and cents at some rate of exchange, so that it may be recorded in the Voucher Register. Usually the rate at which the draft could be settled on the day of its receipt is the proper one at which to evaluate the

1"Preferred stock dividend declared December 15, 1932 payable January 25, 1933—$209,609.00"—American Ice Co—1932
2If the client simply sets aside the dividend in a special bank account, and disburses it itself, the debit is to "Dividend Cash".
dollar cost of the goods. At the time of payment the difference between the estimated and the actual cost can be charged or credited to Exchange Costs,—or other similar account.

In the case of the open payable balances at the audit date, these should be adjusted (if the adjustment is sizable) to the market rate of exchange through the Exchange Costs account.

547. Legal Fees.—The auditor should always request the client to secure from his attorney a bill for his legal services up to the audit date. This request is especially urgent in the case of a newly organized business for the fees are likely to be very heavy. More important than the ascertaining of the liability to the lawyer is the ascertaining of the reason for the lawyer’s services. Insistence in securing a satisfactory answer to this inquiry may reveal extremely important actual, and/or contingent, liabilities. If the auditor can not secure satisfactory action from the client, he must make an adequate footnote on the balance sheet and/or a comment in the report.

548. Contractors’ Accounts.—Whenever a contractor’s accounts are being examined, the auditor should remember that it is not unusual for a contractor to have to do over again a substantial portion of one or more jobs. If so, the estimated cost thereof must be set up at once both as an expense and as a liability. As items of this sort are not to be found in the books of account, the auditor must "audit" the client on these matters.

549. Guarantees.—Now-a-days some goods are sold with a dependable guarantee that the item will be serviced free of charge for a certain period, and, in some instances even during the entire life of the article. That such guarantees cost substantial sums is well known. Therefore, in such instances as those, the auditor must make provision therefor by making some such entry as:

(1) Sales
   Deferred Income from Service and Repairs xx
   OR
   Service and Repair Expense xx
   Provision for Free Service and Repairs xx

In entry #1 the amount set aside includes an element of (expected) profit from repairs deferred to the future when the repairs are made, whereas in entry #2 the amount set aside is the estimated cost of the repairs. Thus when entry #1 is used, the actual cost of the repairs and services are expensed and the proper portion of the "deferred income" account is then transferred to realized income. When entry #2 is used, the actual cost of the repairs and services is charged to the "provision" account. In either method constant supervision is required to see that the "deferred income" or "provision" account is stated at an essentially accurate amount. Indeed, this is the crux of the problem.

550. Sundry Expenses.—The accrual of such expenses as gas, electricity, water, dues, etc. is unusual on large audits unless the amount is sizable. Ordinarily there will have gotten into these profit and loss accounts twelve monthly charges, i.e. Dec. to Nov. inclusive. If so, the auditor is generally content to pass over the unrecorded current December liability.

1It is often feasible to charge or credit the difference to the merchandise. In some instances it is the ONLY correct entry to make.
550a. Audit Program.

(1) Interest.
   (a) Ascertain the date to which the interest has been paid.
   (b) Make inquiries concerning existence of interest on accounts payable.
   (c) When possible always develop the interest on the same schedule as the one showing the principal amount.
   (d) Review the balance sheet items for unnoticed interest bearing obligations.
   (e) Refer to "last period's schedule of accrued interest payable to see what items were included.
   (f) Keep in mind that interest is often accruing on past due taxes, judgments, etc.

(2) Taxes.
   (a) Federal income taxes are a liability of the period in which the profit was earned.
   (b) On a first audit, review the past income tax returns to see if there are any obvious errors.
   (c) In the case of property taxes, ascertain carefully the period to which it applies. Are the rates and/or the assessed value to be changed?
   (d) As to contested assessments, see section 530 in the text.

(3) Commissions.
   (a) When there are traveling salesmen, the auditor is required to make a special review of their expense and salary accounts for the purpose of seeing that they are allocated to the proper period.

(4) Wages.
   (a) Proportional methods for ascertaining the accrued payable are often satisfactory when the weekly payrolls are fairly constant in amount. Accurate methods are always preferable.
   (b) Do not fail to accrue salaries of officers.
   (c) Bonuses, etc. to officers should be checked to directors' minutes.

(5) Dividends.
   (a) Ascertain what restrictions, if any, exist in the by-laws, preferred stock provisions, etc. on the declaration of common dividends.
   (b) Check all dividends declarations to the authorizations in directors' minutes.
   (c) See that the amount declared is on the outstanding stock only. Never allow as income dividends erroneously declared on treasury stock.
   (d) Satisfy yourself as to the legality of the dividend. For your own information at least, satisfy yourself that the declaration was or was not wisely declared.
   (e) Show accumulated preferred dividends as a balance sheet footnote. State definitely when the last payment was made and the total amount accumulated to date.
   (f) When the business makes its own disbursement of dividends, the dividend payable account must receive at least a satisfactory test-check audit.
   (g) When a trustee makes the dividend disbursements for the client, the preferred method is to show both the asset and the liability which represents the uncashed dividend checks. These two items should be verified by direct correspondence with the trustee.

(6) Legal Fees.
   (a) Very often more important than the ascertaining of the outstanding liability to the lawyer is the ascertaining of the reason for the lawyer's services. Undisclosed liabilities are thereby often disclosed to the auditor for the first time.
1. What investigation of unclaimed wages would you make on a balance sheet audit?
2. How would you cover Judgments on an audit?
3. What is the auditor's duty in regard to verifying the Dividends Payable account?
4. Explain in detail how you would handle invoices payable in foreign money.
5. Give three ways in which accumulative preferred dividends may be shown on the balance sheet.
6. What would you do if you found that there was no authorization in the directors' minutes of a dividend which had been paid?
7. How should the amount of the provision for accrued salaries and wages be ascertained?
8. In connection with what kind of insurance is there apt to be a liability to be accrued?
9. When is it permissible to overlook the accrual of gas, water and electricity bills?
10. How might you make certain that you would not overlook the possibility of accrued interest payable on accounts payable?
11. Why is it better to use the word, Provision, than the word, Reserve, in designating an Estimated liability?
12. A cash deposit has been made with a trustee to pay a declared dividend. The corporation goes bankrupt before the fund is fully disbursed. What are the rights of the unpaid stockholders?
13. Is it necessary to show on the balance sheet the cash deposit for bond coupon interest and the liability for the coupons, or may the two accounts be omitted seeing that they are equal in amounts?
14. Need the auditor review prior federal income tax returns? Elaborate your answer.
15. When is it necessary to set up a liability provision for freight?
16. When is the liability for federal taxes incurred?
17. Is it permissible for an auditor to omit amounts due to employees under a profit sharing arrangement when he cannot ascertain the exact amount thereof?
18. What is the most important reason for ascertaining the amount of the legal fees payable?
19. A client has received from the Treasury Department a notice of an additional assessment of $250,147.18 for past taxes and interest thereon. The client is ready to contest the government's claim. How will you set up this proposed assessment on your balance sheet? Give the exact words.
20. When should the liability for an audit be taken up?
21. How should deposits by customers of public utility companies be audited?
22. Describe a good method for a bank to use in handling the giving out of its customers' paid checks and statements.
CHAPTER 35

THE VERIFICATION OF CURRENT Deferred INCOME

551. General Discussion. Deferred income is income which has been received, but which has not been earned. Thus rents which are received in advance are deferred income. Moreover, deferred income is often exactly the opposite of prepaid assets. Indeed, in many instances that which is deferred income on the payee's books is a prepaid asset on the payer's books. For example, rent paid in advance is a prepaid asset on the tenant's ledger, but an item of deferred income on the landlord's records.

Among the numerous items generally classified as Current Deferred Income, the following ones are very common: interest, discount, rent, subscriptions, dues, carefares, and meal tickets.

The purpose of the deferred income account (or accounts) is: (1) to divide certain income items over the periods to which they properly belong, irrespective of when payments for them are received, and (2) to record at statement periods the "liability" for the future services, or goods which are due to the payer.

As deferred income items are not usually payable in cash, and as the amount at which they are stated on the balance sheet includes an element of profit, it is not ordinarily advisable to treat them as current liabilities, unless (1) the prepaid assets have been classified as current assets, or (2) the deferred income is payable with goods included in the current inventories, as when a gasoleno station has unpresented coupon outstanding. However, deferred income items which represent obligations to be discharged within one year are so like current liabilities as to require their being set up directly after them. Deferred income which will not be earned until after one year from the date of the balance sheet should be regarded as a long term liability.

Whether or not the auditor can afford to slight the auditing of certain deferred income items is NOT wholly dependent upon there being twelve months' credits to the income (profit and loss) account under consideration. The amount involved and similar factors should have a decided bearing upon his decision as to the proper amount of auditing that is necessary. Moreover, the writer feels that the auditor should make some outward show and actual insistence that ALL (small as well as large) deferred income items be carefully accounted for by the client. Such a program tends to keep the client's accounting force "on its toes." On the other hand, the auditor should not spend much time in checking these items when they are KNOWN to be very small. Large amounts MUST always receive very careful auditing, even in those instances where the determination of the correct balance is largely a matter of opinion and/or estimates rather than of ascertainable facts. Again, in many instances the auditor should realize that his greatest reliance in the

1 Or payable with other current assets. 2I.E., some auditors feel that they can slight the auditing of certain deferred income items provided they see that there are 12 months' credits to income. 3I.E., the auditor must not be lulled asleep by the fact that the balance, as stated by the CLIENT, is small.
accuracy of the final balance is in the adequacy of the system of internal check and the accounting records and methods. Accordingly, in such cases he should direct his main examination into these channels, knowing that if they are in good order, the final balance of the account will be essentially accurate. Finally, in a few instances he may have to rely largely or solely upon the actuarial department's computations. If so, both the balance sheet and certificate should be clearly qualified.

552. Prepaid Subscriptions.--As it is very common indeed for magazine publishers to take advance payment at reduced rates for a year's, or more, subscription, the auditor must pro-rate the effect of those cash receipts over the proper periods. If this is not done, the profit and loss statement and the balance sheet will be decidedly inaccurate. It is unreasonable to suppose that "according to the law of averages the absorbing of income of several future periods into the current period when the cash is received will give a figure in the income accounts approximately equal to that secured by accurate prorating." Moreover, if the income is absorbed in the period when the money is received, there will not be shown on the balance sheet any "liability" thereon.

Finally, if the Prepaid Subscription account contains a large amount of subscriptions extending beyond one year, some segregation of this amount must be made, for it is comparable to a long term liability. (See section 557).

553. Tokens, Coupons, Etc.--Tokens, coupons and tickets, which are often issued by street car companies, gasoline stations, lunch rooms, railroads, amusement companies, etc., are excellent examples of current deferred income. In fact, in the case of a gasoline station, for example, the amount of coupons outstanding is practically a current liability. These coupons will be redeemed very shortly and must be liquidated with gasoline, a current asset.

553a. Audit Program.
(1) Divide deferred income items into two classes:
   (a) Those which will be liquidated within one year from the balance sheet date.
   (b) Those which will be liquidated after one year from the balance sheet date.
(2) Place items falling in #1-a under a separate main heading (CURRENT DEFERRED INCOME) on the balance sheet directly after the current liabilities, unless
   (a) the prepaid assets have been classified as current assets, or
   (b) the deferred income is to be liquidated chiefly out of present or future current assets. In such instances it is usually more correct to treat these items as current liabilities.
(3) Place items falling in #1-b under a separate main heading (LONG-TERM DEFERRED INCOME) on the balance sheet directly after the fixed liabilities.
(4) Never give the client's office force the impression that you are not very much interested in the strict accuracy of small deferred income items, even though in fact this may be so on a balance sheet audit.
(5) Do not be lulled asleep by the fact that the final balance, as given by the client, is small. A review and scrutiny of the situation may disclose a large error therein.
(6) If the final balance is largely a matter of opinion and/or estimates, do not fall into the common mistake of accepting the client's figures without having any genuine confidence and belief in their essential
accuracy. Moreover, go over carefully and critically the client's methods, computations, etc.. Remember that: "Inertia and fear are the opiates of the sterile auditor whenever he is faced with the possibility of having to oppose the client on a matter of mere (?) opinion."

(7) If it is necessary to accept the figures of the client's actuarial department, state this qualification both on the balance sheet and the "Auditor's Certificate".

(8) When the final balance can not be verified except through a prohibitive amount of auditing, the auditor should ascertain if a review, scrutiny and test check (assuming a good system of internal check, accounting methods and adequate records) of the accuracy of the underlying journal entries will not be sufficient to satisfy himself as to the essential accuracy of the client's figure.

(9) Do not accept without GOOD PROOF the client's statement that: "In our business the law of averages makes it unnecessary to prorate the so-called deferred income items." Furthermore, even if the client's statement concerning the income sheet be true, remember that the effect of such an accounting policy on the substantial accuracy of the balance sheet must also be taken into consideration. Any such omission, even if small at the audit date, should always be mentioned in the report, and possibly in the certificate.

REVIEW QUESTIONS

1. For the year 1929 a rent income account contained 12 monthly credit entries recording the receipt of the prepaid rent from February 1929 through January 1930 inclusive. (January 1929 rent was recorded and taken up as income in 1928). Auditor K is satisfied with these entries inasmuch as a full year's rent is taken up each year into profit and loss. What is your position on the matter?
2. What is the purpose of deferred income accounts?
3. Advance all of the reasons you can for setting up deferred income as a separate caption distinct from the current liabilities.
4. Where on the balance sheet would you place deferred income accounts which are not to be settled within one year?
5. It is often stated that deferred income is the exact opposite of prepaid assets. Explain.
6. Advance all of the reasons you can for including certain deferred income items under current liabilities.
7. Where would you place "Unearned Revenue from Service Contracts, etc.. $1,772,059.77"? This appeared on the 1930 balance sheet of the Burroughs Adding Machine Company.
CHAPTER 36
THE VERIFICATION OF LONG-TERM LIABILITIES

554. General Discussion.

555. Deferred Income.

556. Bond Premium

557. Explanation of Plate 178.

558. Deposits.

559. Pensions.

560. Mortgage Payable.

561. Explanation of Plate 179.

562. Explanation of Plate 180.

563. Explanation of Plate 181.

563a. Audit Program

Review Questions.

554. General Discussion.-- Very often the designation "long-term liabilities" is synonymous with "funded debt". In this discussion, however, the term "funded debt" will be reserved for those debts which really are covered by a fund of assets. For example, if a bond issue provides for a sinking fund, it is properly called a funded debt. If, on the other hand, the issue merely provides for a sinking fund reserve, it is not true funded debt.

Furthermore, for our purposes the caption Long-Term Debt includes much more than bond issues. Most debts, or deferred credits, which will not be cancelled until after one year from the date of the balance sheet may be classified as long term liabilities. Thus under this heading one often finds:

1. Deferred Income, which represents income that will not be earned until after one year from the balance sheet date.

2. Deferred Credits which will offset future expense charges (see section 558). Bond Premium, for illustration, is an outstanding example of this group. The maturity thereof must, of course, be after one year from the balance sheet date.

3. Deposits which by contract or otherwise cannot be withdrawn, or are not likely to be withdrawn until after one year from the balance sheet date.

4. Bonds, debentures, long-term notes, certificates of indebtedness, mortgages, and any other similar obligations secured or unsecured, which mature after one year from the balance sheet date.

The reason for separating these items from Current Liabilities and from current Deferred Income lies in the fact that they are not to be liquidated directly or indirectly out of the current assets (or services) which are now in existence. Moreover, in the case of such liabilities as those listed in group 4, the loan has been made to the company on the strength of its future earning power and, if secured, on the value of the plant properties pledged thereon, rather than on the soundness of its present current position.

555. Deferred Income.-- As we shall see, Deferred Income which will not be earned until after one year from the balance sheet date is not exactly a long-term debt; therefore, many auditors prefer to set it up as a separate balance sheet caption just before the long-term debts.
Obviously, this type of deferred income cannot be looked upon either as a current liability or as current deferred income. Each of these two latter items has a very definite adverse effect on the present current assets, whereas long-term deferred income has no such effect. Likewise, as noted above, it is not a long-term debt in the sense that it must be liquidated at face value. That is, there is usually an expected element of profit in the figure appearing on the balance sheet. Therefore, to repeat, in many auditors' opinion this fact is a valid objection to showing long-term deferred income under long-term liabilities.

555. Bond Premium.-- If a $100, 6%, 20 year bond, interest payable semi-annually, is sold to yield 5% interest payable semi-annually, it will bring $112.55, i.e., the premium is $12.55. The accounting entry is, of course, as follows assuming that $2,000,000 (par value) worth of bonds are sold.

Cash
First Mortgage Bonds Payable
Premium on First Mortgage Bonds

<table>
<thead>
<tr>
<th>Cash</th>
<th>2,251,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Mortgage Bonds Payable</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Premium on First Mortgage Bonds</td>
<td>251,000</td>
</tr>
</tbody>
</table>

It can be seen that in an issue of this size and under these conditions, it is important for an auditor to see that the premium is not treated either as current income or as surplus.

The premium account is, of course, neither like a current liability nor like a current deferred income account. It does not have to be liquidated, except for a small portion thereof, out of present current cash, goods, or services. On the other hand, although it is often looked upon as merely an account whose effect is to decrease future bond interest expense, it can be properly thought of as a long-term debt without any difficulty. For example, instead of making the entries in (a) below, one could make the entries as in (b). These latter entries show very clearly that bond premium is in reality a long-term debt with serial maturities.

(a)

<table>
<thead>
<tr>
<th>Bond Interest Expense</th>
<th>60,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>-60,000</td>
</tr>
<tr>
<td>Premium on First Mortgage Bonds</td>
<td>3,725</td>
</tr>
<tr>
<td>Bond Interest Expense</td>
<td>3,725</td>
</tr>
</tbody>
</table>

To record the semi-annual bond interest payment and the amortization of the bond premium account.

(b)

<table>
<thead>
<tr>
<th>Bond Interest Expense</th>
<th>56,275</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium on First Mortgage Bonds</td>
<td>3,725</td>
</tr>
<tr>
<td>Cash</td>
<td>60,000</td>
</tr>
</tbody>
</table>

To record the semi-annual bond interest payment.

It has been suggested above that a small portion of the premium account (here 2 x $3725) is in reality a current liability, since it is payable within a year from the date of the balance sheet. Whether or not such sums should be set up as a current liability would depend upon the effect it would have on the current ratio. If the business is in poor shape, this separation would usually be worthwhile. Ordinarily, however, it would not be separated from the long-term portion of the account, even though this
### A SCHEDULE ON BOND PREMIUM PLATE 178

Warren Bros., Inc.
Bond Premium Amortization Schedule
Audit for Year Ended Dec. 31, 1900

<table>
<thead>
<tr>
<th>Date</th>
<th>Total Interest @ 6% 3% Semi-annual</th>
<th>Net Expense @ 5% 2 1/2 % Semi-ann.</th>
<th>Premium Amortization Book</th>
<th>Bond Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1900</td>
<td>Jan 1 60000.00</td>
<td>56275.00</td>
<td>3725.00</td>
<td>2251000.00</td>
</tr>
<tr>
<td></td>
<td>July 1 60000.00</td>
<td>56181.86</td>
<td>3818.14</td>
<td>2247275.00</td>
</tr>
<tr>
<td>1901</td>
<td>Jan 1 60000.00</td>
<td>56086.42</td>
<td>3913.58</td>
<td>2239543.18</td>
</tr>
<tr>
<td></td>
<td>July 1 60000.00</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**OMISSIONS**

| 1920     | Jan 2 60000.00                       | 50243.91                            | 9756.09                    | 2000000.00 |

These bonds were sold to Bratcher, Wilders & Davis, investment bankers of St. Louis, on a 5% basis. No commission paid.

($2,000,000 - 6% - 20 year - gold - 1st Mtg. - interest Jan. 1 and July 1 dated Jan. 1, 1900.)

(Reader's Note: For the Journal entries of July 1, 1900, see methods (a) and (b) of section 556.)

557. Explanation and Comments.--This plate shows a common method of working up the proper amount of the periodic premium amortization.

As stated in the text, the Bond Premium account is not a true Deferred Income item. It is more in the nature of a long term liability. The cash interest payments, as stated in method (b) of section 556, are payments for the true (effective) interest plus a gradual return of the original premium paid in.
omission is theoretically incorrect procedure. The reader of the balance sheet is charged, it is believed, with knowing that cash interest payments are due in the near future at the bond rate.

Finally, if any expense is incurred in connection with the bond issue, it should be charged to the premium account.

557. See Plate 178.

558. Deposits.--Deposits, secured from customers as security for possible unpaid debts, etc., are often a sizable liability of gas, electric, and water companies. Such cash does not have to be set aside in a separate fund, but the liability thereof must be kept separate. Usually interest is payable on such sums at the time the deposit is withdrawn. Therefore, the auditor should see that all accrued interest payable has been computed up to the audit date. If it is definitely known that a deposit will not be claimed, it should be written off as miscellaneous income.

Where deposits exist, the auditor should make a careful survey of the special books, stationery, and accounting methods for handling the transactions. A good system of internal check should be in force at all points.

Whenever the client uses pass-books, or the equivalent, for deposits payable, the auditor should assign a junior to the task of verifying that each pass-book that is presented during the time he is on this job is in agreement with the company's records. In addition to this, confirmation forms should be sent out to cover both inactive, and large deposits. If, desired, the negative form of confirmation may be adopted.

In the case of a bank (here deposits are current liabilities), the clerk who is assigned the task of giving out the cancelled checks and statements to depositors who call for them should be instructed to refuse everyone access to her cage. This procedure is based on the assumption that different clerks prepare the statements from those who keep the depositors' ledgers. If the same clerk does both, the clerk (a new person altogether) who gives out the statements must compare the balances with the depositors' ledgers. Generally speaking, those statements which are not called for personally should be mailed. They should not be kept on hand.

559. Pensions.--The Allowance for Pensions account, representing accrued pensions which will eventually be paid to employees who have worked for the company for a certain number of years, etc., is not a true liability in most instances. That is to say that although there is a strong moral obligation on the corporation's part to continue its policy of paying pensions, and although an abandonment of the policy would undoubtedly have a very adverse effect on the morale of its employees, nevertheless, there is no legal liability to the employees. Moreover, it is obvious that if the corporation becomes too hard pressed, the pension system will be abandoned. Therefore, the auditor can not insist that the allowance be shown as a liability if the client desires to show it as appropriated surplus.

On the other hand, if the client desires the auditor to indicate the account's proper position on the balance sheet, the auditor should unhesitatingly show it as a liability. The writer's position is that since there is no intention of dropping the pension system, the corporation must look upon the balance of this account as a liability if it is to get a proper picture of its financial position as a going concern.

560. Mortgage Payable.--For our purposes, mortgages may be divided into real estate mortgages and chattel mortgages. Real estate mortgages are those which are secured by real property (a legal term), whereas chattel mortgages are secured by personal property. Machinery and equipment are common types of personal property which are pledged by businesses to secure a chattel mortgage.
Generally speaking, mortgages have a specified due date, and, of course, bear interest, which is often payable quarterly or semi-annually in advance (see Plate 123). Obviously, the amount of the mortgage note should be considerably less than the value of the pledged property, if the loan is to be properly secured. Moreover, the maturity of the note must be considerably within the life of the asset for otherwise the security would slip out from under the mortgage. Likewise, the mortgage should provide for installment reductions, payable at the regular interest dates, in sums exceeding the amount of depreciation or obsolescence of the pledged assets.

Beside the mortgage (Plate 122), there is also a mortgage note or notes (Plate 123). The note is the evidence of the indebtedness, whereas the mortgage is the instrument conveying the title of the security to the mortgagee in case the debtor defaults. When there is only one note, partial payments are endorsed thereon. On the other hand, when several notes are given by the mortgagee, it is customary for him to pay up each note in full as it matures, the cancelled note being returned to him.

Mortgages are given on real estate investments in order to increase the rate of yield on the investment. Thus, if an investment yields 10% on cost, it can be made to yield 14% on the sum invested if a 6% mortgage is given to the amount of one-half of the cost. Of course, on many occasions a mortgage is given because the mortgagee hasn't the requisite cash to make a freehold purchase; i.e., on such occasions the mortgage is not given with the thought of increasing the rate of yield, but solely to satisfy the balance of the purchase price.

Before auditing the mortgage payable account, the auditor should request the client to prepare a schedule of the mortgages payable on working paper whose heading, etc., have been drawn up by the auditor. Such a schedule will be similar to the one in Plate 179. When only a single mortgage (or a very few) is in existence, the auditor will generally prepare the schedule himself. Plate 180 is illustrative of this kind of analysis sheet.

Even in a balance sheet audit, it is advisable to check through the account from beginning to end unless the transactions are so numerous that a substantial test must suffice. The auditor should ascertain the nature of each transaction which gave rise to a mortgage and satisfy himself that the entries thereon are correct. The auditor should also check the interest, and the partial payments on principal against cancelled checks, cancelled notes (if any), and against the provisions of the mortgage deed. The identifying of interest payments against definite mortgages is invaluable, since such a procedure has often disclosed undisclosed mortgages. This is especially true in the case of solo proprietorships, and partnerships. If any mortgage note has been fully satisfied, the cancelled mortgage (see last two pages of Plate 121 where both the bank and city clerk have discharged the mortgage) as well as the note and the check, should be seen. And, if the public records are examined, it is desirable to verify the recording of its having been satisfied.

As a mortgage on being recorded in the public records becomes a lien which can not be ousted by a subsequent mortgage, an auditor who is equipped with a knowledge of how to look up mortgages, judgments, etc., in the public registry is in an excellent position to audit this account most satisfactorily.

The notes and mortgage being held by the mortgagees, it is not possible to check these documents against the schedule. Therefore, it is advisable and customary to verify the unpaid balance and other details by direct correspondence with the mortgagees. If mortgages have been customarily placed with certain banks, these banks should be inquired, even though the books do not show any mortgages payable to them at the audit date.

1. It may be interjected here that legally a mortgage on a piece of property has not been reduced unless the reduction payments have been recorded in the Public Records, hence some auditors, in a situation of this kind, show the mortgage gross with the unrecorded payments as deductions, the net being the amount extended.
American Institute of Certified Public Accountants

A SCHEDULE ON MORTGAGES PAYABLE PLATE 179

The Clarkson Realty Corp.
Mortgages Payable - Prepaid Interest

Audit for Year Ended Dec. 31, 1930

<table>
<thead>
<tr>
<th>F 1st Mtg.</th>
<th>S 2nd Mtg.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessed</td>
<td>--Principal----</td>
</tr>
<tr>
<td>Value of Property; Original to 1/1/30 Property</td>
<td>Payments a 12/31/30 in Dated Due 1930</td>
</tr>
<tr>
<td>Location</td>
<td>Mortgage This Year</td>
</tr>
<tr>
<td>250000</td>
<td>125000 F</td>
</tr>
<tr>
<td>69 Morris City</td>
<td>1/9 25000 Y</td>
</tr>
<tr>
<td>100000</td>
<td>50000 F 4/1</td>
</tr>
<tr>
<td>City 61 Myrtle</td>
<td>5000 Y</td>
</tr>
<tr>
<td>20000</td>
<td>7000 S 8/1</td>
</tr>
<tr>
<td>76 Osborne Poe, Ind.</td>
<td>1000 Y</td>
</tr>
<tr>
<td></td>
<td>820000</td>
</tr>
<tr>
<td></td>
<td>365000</td>
</tr>
<tr>
<td>1435000</td>
<td>455000</td>
</tr>
<tr>
<td>O K per G/Ledger</td>
<td>O.K.</td>
</tr>
<tr>
<td>P Payments up to 1/1/30</td>
<td></td>
</tr>
<tr>
<td>Y Payments in 1930</td>
<td></td>
</tr>
</tbody>
</table>

For the Audit Procedure, see the Audit Program

SUMMARY

<table>
<thead>
<tr>
<th>Class</th>
<th>Balance 12/31/30</th>
<th>Payments Due in 1931</th>
<th>Balance 12/31/31</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Mortgage</td>
<td>412000</td>
<td>55000</td>
<td>357000</td>
</tr>
<tr>
<td>Second Mortgages</td>
<td>43000</td>
<td>8000</td>
<td>35000</td>
</tr>
<tr>
<td>From Above</td>
<td>455000</td>
<td>63000</td>
<td>392000</td>
</tr>
<tr>
<td>To DD</td>
<td>To B/S</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

561. Explanation and Comments.-- This plate represents a common type of analysis sheet on mortgages payable. The reader should study it noting particularly its special features such as (1) the value and location of the mortgaged property; (2) the name and address of the mortgagees; (3) the information on prepaid interest and on interest paid; and (4) the separation into first and second mortgages.

Note especially that of the $455,000.00 due on the mortgages, the auditor has transferred $63,000.00 to schedule DD, a current liability.
A SCHEDULE ON MORTGAGES PAYABLE PLATE 180

The Rollins Real Estate Investment Corp.
First Mortgage on the Reed Block, Woburn, Conn.
Audit for the Year Ending Dec. 31, 1930

Barksdale 1-7-31
Schedule DD

$300,000 1st Mtg. Dated 12/17/27 6% Due 12/17/37
$30,000 due on 12/17 of each year. 10 notes
1st National of Woburn, Conn.

<table>
<thead>
<tr>
<th>Balance per G/L 12/31/30 and per certificate attached</th>
<th>DD-1</th>
<th>210000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>DD-1</td>
<td></td>
<td>To B/S</td>
</tr>
</tbody>
</table>

Original Mortgage
Payments to date - Notes #1 and #2 of $30000 each
Balance per G/L and our report 12/31/29
Payment 12/17/30 Note #3 by check #7183
Balance 12/31/30

AUDIT PROCEDURE

Examined the cancelled note #3 and the cancelled check #7183, and received confirmation of the outstanding balance per certificate attached DD-1.

Interest paid in advanced to 12/17/31. See Schedule J

562. Explanation and Comments.-- Observe that all of the important facts about the mortgage are given a prominent position in the heading of the schedule. Also, note that the cancelled note and check were examined, and that the outstanding balance, etc. was verified by direct correspondence with the mortgagor.

Attention is called for the first time, it is believed, to the make-up of this type of schedule. On the opening line is stated the final conclusion of the whole analysis sheet. Then, starting in one or two lines below it, there is developed the details which lead to this conclusion.

Although a $30,000.00 note falls due within a year of the balance sheet date; i.e., on Dec. 17, 1931, it has not been placed among the current liabilities. If it had fallen due in May, for example, the auditor should have classified it as such.

Under the present arrangement the balance sheet caption should be:
SERIAL FIRST MORTGAGE, $30,000 annually, 6%, due 1937 -- -- $210,000.00
A SCHEDULE ON MORTGAGES PAYABLE PLATE 181

Holden, Inc.
First Mortgage Payable

B/S Audit for the Two Years Ended Dec. 31, 1930

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Payable</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2/1/28</td>
<td>FP Connors, Inc.</td>
<td>200000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2/1/29</td>
<td>Cash Payment: check #8165</td>
<td>40000</td>
<td>40000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2/1/30</td>
<td>Cash Payment: check #13635</td>
<td>40000</td>
<td>40000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Balance per G/L 12/31/30</strong></td>
<td>120000</td>
<td></td>
<td></td>
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Prepaid Interest - $4200 paid 6 mo. in advance on 9/1/30 check #14189

**See Below** 700.00

To K-8

AUDIT PROCEDURE

The terms of the mortgage, etc. are abstracted on Schedule PP-1. All provisions have been fulfilled.

Due to the poor condition of Holden, Inc. at 2/1/28, Mr. F.P. Connors, Chairman of the Board of Directors, agreed to cancel a current debt of $20350.12 due to him in return for the above $200000 first mortgage. Mr. Connors practically owns Holden, Inc. holding 10000 common shares out of 12000 shares outstanding.

We verified that the original debt due Mr. Connors was a legitimate and regular trade payable. We also examined the two cancelled checks, (0 K) The balance was verified with Mr. Connors. See schedule PP-2. The cancelled notes were also examined, #185 and #186. (0 K)

We had Holden, Inc. register these payments in the public records. The Prepaid Interest of $700 was verified by cancelled check #14189, and computation.

BALANCE SHEET PRESENTATION

First Mortgage Payable (7%, due serially 1928-33) $200000

Less - Payments to date to Mr. F.P. Connors 80000

Due February 1, 1931 as above 40000

Balance Outstanding after February 1, 1931 120000

80000

NOTE: In the report comment clearly on just how this mortgage arose.

563. Explanation and Comments.—Although there are several interesting features in this schedule, nevertheless, only one of them will be stressed.

The reader should note that the schedule is so drawn up as to show what the CONTRA ACCOUNTS were. On many schedules this arrangement is imperative. Theoretically, being a balance sheet audit, the auditor could have been satisfied with confirming the $120000 balance of the mortgage direct with the mortgagor. But, if he had done so, he would not have ascertained that Mr. Connors had been given a preferred claim (because he was Chairman of the Board), in the form of a first mortgage, over the claims of the other unsecured creditors. In short, an analysis of an account often yields vital information which a mere verification of the final balance by direct confirmation will not yield.
If the equity in a piece of property on which a mortgage already exists is purchased, it may be that the mortgagor has not agreed to look to the new purchaser for final satisfaction of his debt but to the original mortgagor. That is, if "bad came to worse" and the property should not sell for a sufficient sum to satisfy the mortgage, the mortgagor could not ask the client to pay the unsatisfied balance. This debt is owed by the original mortgagor; i.e., the one who sold his equity in the property to the client.

In order to show this situation on the balance sheet, the depreciated value of the property is often shown with the mortgage subtracted therefrom. In brief, only the purchaser's equity in the property is carried as an asset. However, the weight of opinion is undoubtedly to the effect that this presentation is not as satisfactory as when the property less the depreciation allowance is carried as an asset, and the mortgage is shown as a liability. This latter presentation is always necessary if the mortgage must be paid off within a year.

Finally, whenever a considerable portion of the loans are second mortgages, they should be stated separately on the balance sheet from the first mortgages. This segregation is very informative because second mortgages are generally payable in installments and are difficult to renew. The report, of course, should show practically all of the information illustrated in plate 179.

561. See Plate 179.
562. See Plate 180.
563. See Plate 181.
563a. Audit Program

(1) Verify the opening balance against prior working papers.
(2) Verify all credits by checking to Cash Receipts book, or other books of original entry. Trace into bank, etc. See that the proceeds were received.
(3) Verify all debits by checking to Cash Payments Book or other books of original entry. See cancelled checks, etc. See that the reductions are genuine.
(4) Foot the account and prove the final balance.
(5) Examine all mortgages paid up during the period. See that they have been discharged by the public registry.
(6) Examine all mortgage notes paid up during the period. Check to general ledger account.
(7) Prepare schedule of mortgages payable from Mortgage Payable Register.
(8) Check copies, if any, of mortgages to the schedule.
(9) Check total of schedule to balance of general ledger account.
(10) Show details of all properties mortgaged.
(11) Examine the public records to see if the mortgages are registered.
(12) Test interest expense account against the principal amounts.
(13) Check partial payments into cash book and thence into the general ledger account. See cancelled checks.
(14) Do same as in #11 to see if partial payments are registered.
(15) Examine by-laws, etc. to see if the mortgages are permitted.
(16) Verify the accrued interest payable.
(17) Examine directors' minutes for authority to issue mortgages.
(18) Verify some of the mortgages by direct correspondence.
1. Wherein is long-term deferred income unlike a long-term debt?
2. Is "Customers' Deposits" in a bank statement a current liability or a fixed liability? Why?
3. Outline a system of internal check for a bank in connection with its Customers' Deposits account.
4. What is a chattel mortgage?
5. Classify the Allowance for Pensions account for the balance sheet. Give reasons for your answer.
6. In what businesses are deposits a fixed liability?
7. When the term is correctly applied, what is a funded debt? What is its general meaning? What is a "fixed" liability?
8. State some principles in regard to the relationship which should exist between a mortgage note and the pledged property.
9. Do you regard the Bond Premium account as an offset to future bond interest expense, or as a liability, or as a - - - - - ? Defend your position.
10. What is the difference between a mortgage note and a mortgage deed?
11. What groups of items are classified in this chapter as long-term liabilities?
12. Draw up an audit program on mortgages payable.
13. How should an auditor audit the Customers' Deposits account on an audit of a gas company?
14. How can you tell when a mortgage deed has been cancelled by the mortgagee, etc.?
15. Point out some of the major differences between a current liability and a long-term debt.
16. Why does the author regard the Bond Premium account as a long-term liability?
17. Wherein is long-term deferred income like a long-term debt?
18. Why should a mortgage deed be registered in the public records?
19. Why should the balances of the mortgage notes be verified by direct correspondence with the mortgagees?
20. When is it permissible to show the client's equity in a parcel of mortgaged property? Is this presentation advisable?
CHAPTER 37

THE VERIFICATION OF BONDS PAYABLE

564. General Discussion.
565. Explanation of Plate 182.
   PLATE 182-The Contents of a Fully Registered Bond.
566. The Trust Indenture.
567. Explanation of Plate 183.
   PLATE 183-Auditor's Excerpts from a Trust Indenture.
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569. Issuance.
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571. Explanation of Plate 185.
   PLATE 185-A Form of Cremation Certificate.
572. Explanation of Plate 183.
   PLATE 186-A Notice of Redemption.
573. The Trustee.
574. Explanation of Plate 187.
   PLATE 187-A Schedule on Bonds Payable.
575. Bond Interest.
576. Coupons.
577. Treasury Bonds.
578. Independent Confirmation
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   PLATE 188-Forms of Balance Sheet Presentation of Bonds Payable.
581. Explanation of Plate 189.
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Review Questions.

564. General Discussion.--For our purposes a corporation bond, plate 182, may be thought of as an evidence of long-term indebtedness, properly signed under corporate seal and promising to pay a sum certain in money at a definite or determinable future date. It is usually negotiable by mere transfer from hand to hand as in the case of money, except that bonds which are registered as to principal must first be endorsed by the owner of record. Moreover, most bonds have a lien on some specific real estate, or machinery and equipment, or securities, but some are secured only by the general credit of the corporation. Such bonds are known respectively as real estate mortgage bonds, equipment bonds, collateral trust bonds, and debentures.

As it is difficult for a business which desires a large loan, running into the millions, or even less, to secure it from one or a few individuals, either because these persons haven't that sum to lend, or because they do not desire to invest so much in a single enterprise, it may issue and find a ready market for bonds of small denominations. The bonds of a single issue are all of equal rank and security, being a part of the same mortgage whose amount is, of course, the total amount of the bonds. In brief, the reader should observe that the mortgage, more commonly known as a deed
of trust or trust indenture, is a distinct instrument from the bonds, the bonds merely evidencing a fractional part or share in this mortgage. Furthermore, the reader should note that whereas the ordinary mortgage has but two parties to it, the mortgagor and the mortgagee, the corporate mortgage provides in addition for a trustee, often a trust company, which acts for the bondholders whenever their rights are in default.

The deed of trust is frequently a voluminous document. It presents with extraordinary care and completeness the obligations, rights, interests, etc. of the trustee, the bondholders, and the corporation. In fact, it is often a model of legal adroitness, providing, as it does, for the solution of all sorts of imaginable contingencies.

Bonds are issued, of course, for numerous reasons. Among the more common ones are those to provide funds (1) for the extension and/or improvement of the real estate; (2) for increasing the working capital; (3) for retiring a matured long-term obligation; (4) for purchasing a complete or controlling interest in a competitor, etc.; (5) for consolidating diverse bond issues by retiring them out of the proceeds of the new unified issue; (6) for funding present floating indebtedness; and (7) for the extension and/or improvement of machinery and equipment.

565. See Plato 182

566. The Trust Indenture.—On the first audit, the auditor should make an abstract of the trust indenture (Plato 183) for his permanent file of working papers, so that on each successive engagement it will not be necessary for him to reread the document.

The following Table of Contents from the first consolidated mortgage of the Anaconda Copper Mining Company will indicate some of the usual provisions to be found in deeds of trust.

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*Table of contents and Marginal Notes are not in the Consolidated Mortgage as executed and recorded.*
THE CONTENTS OF A FULLY REGISTERED BOND  PLATE 182

(FORM OF SERIES "A" FULLY REGISTERED BOND)

UNITED STATES OF AMERICA
STATE OF MONTANA

No. ...... ANACONDA COPPER MINING COMPANY

$..........

REGISTERED FIRST CONSOLIDATED MORTGAGE SERIES "A" SINKING FUND
SIX PER CENT. GOLD BOND.

Due February 1, 1953

ANACONDA COPPER MINING COMPANY, a Montana Corporation (herein-
after promises to pay to
or registered assigns, on the first day of February, 1953,
dollars,
and to pay interest on said principal amount from the date of this
bond, at the rate of six per cent per annum, semi-annually, on the
first day of August and the first day of February in each year. Pay-
ment of the principal and interest of this bond will be made at the
principal office of the Guaranty Trust Company of New York, in the
Borough of Manhattan, City of New York, or, at the option of the
registered holder, at the head office of The National City Bank of
New York, in the Borough of Manhattan, City of New York, in gold coin
of the United States of America, of or equal to the standard of
weight and fineness as it existed on February 1, 1923.

Interest upon this bond will be paid without deduction for such
portion of any Federal income tax, not in excess of two per cent of
such interest, which the Company or its paying agents may be permitted
or required to pay thereon or to retain or deduct therefrom under any
present or future law of the United States of America. Under the
conditions provided in the Consolidated Mortgage, the Company will
reimburse the owner of this bond, if resident in Pennsylvania, for
any personal property tax or taxes which shall lawfully be imposed
upon and paid by him pursuant to the laws of the Commonwealth of
Pennsylvania by reason of the ownership of this bond, but not in ex-
cess of four-tenths of one per cent of the assessed value hereof in
any year, and only upon receipt by the Company, within sixty (60)
days after any such payment, of proof satisfactory to the Company
of the payment of such tax or taxes together with written request for
the reimbursement thereof.

This bond is one of an issue of coupon and registered bonds of
the Company, known as its First Consolidated Mortgage Gold Bonds, and
herein termed Consolidated Bonds, limited to the aggregate principal
amount of $200,000,000 at any one time outstanding, and issued and to
be issued in one or more series (which may vary as to interest rate,
redemption price and otherwise), under, and equally secured by, an
indenture of mortgage and deed of trust, dated February 1, 1923,
herein termed the Consolidated Mortgage, made by the Company to
Guaranty Trust Company of New York, as Trustee. The said Consolidated
Mortgage, to the extent therein set forth, provides for the prior
security of the Ten-Year Secured Gold Bonds of the Company issued
under a trust agreement, dated January 2, 1919, made by the Company
to Guaranty Trust Company of New York, as Trustee, and for the pay-
amount of said Ten-Year Secured Gold Bonds in priority to the Consolidated Bonds. For a description of the properties mortgaged and pledged, the nature and extent of the security, the terms and conditions upon which the Consolidated Bonds may be issued and are secured, and the rights of the holders of such bonds and of the Trustee in respect of such security, reference is made to the Consolidated Mortgage.

This bond is subject to redemption on any interest date at the election of the Company, or through the operation of the sinking fund created for the bonds of this Series pursuant to the Consolidated Mortgage, at 105% of so much of the principal amount hereof as may be redeemed on or before February 1, 1933; at 103 1/2% of so much of the principal amount hereof as may be redeemed after February 1, 1933, and on or before February 1, 1943; and at 102% of so much of the principal amount hereof as may be redeemed after February 1, 1943, and prior to maturity, upon at least thirty (30) days prior notice by publication in two newspapers published in the Borough of Manhattan, City of New York, all as provided in the Consolidated Mortgage.

In case an event of default as defined in the Consolidated Mortgage shall occur, the principal of the Consolidated Bonds may become or be declared due and payable, in the manner and with the effect provided in the Consolidated Mortgage.

This bond is transferable by the registered holder hereof, in person or by attorney duly authorized, at the office or agency of the Company in the Borough of Manhattan, City of New York, upon surrender and cancellation of this bond, and a new registered bond of this Series will be issued to the transferee in exchange herefor, as provided in the Consolidated Mortgage, and on payment, if the company shall so require, of the charge therein provided for.

Series "A" Consolidated Bonds with coupons are issuable in the denominations of $1,000 and $500 each. Series "A" Consolidated Bonds fully registered without coupons are issuable in the denominations of $1,000 and authorized multiples thereof. In the manner prescribed in the Consolidated Mortgage and upon payment of the charges therein provided, coupon bonds of this Series, of either denomination, may be exchanged for a like aggregate principal amount of coupon bonds of this Series of the other denomination, and coupon bonds of this Series of either denomination in the aggregate principal amount of $1,000 or multiples thereof, may also be exchanged for a like aggregate principal amount of registered bonds, without coupons, of this Series. Any such registered bond, in like manner and upon payment of the charges provided in the Consolidated Mortgage, may in turn be exchanged for a coupon bond or bonds of this Series for the same aggregate principal amount and bearing all unmatured coupons.

No recourse shall be had for the payment of the principal or interest of this bond or any part thereof, or for any claim based thereon or otherwise in respect thereof, or of the indebtedness represented thereby or of the Consolidated Mortgage, against any incorporator, stockholder, officer or director, past, present or future, of the Anaconda Copper Mining Company, or any successor corporation, either directly or through the Company or such successor corporation, whether by virtue of any statute or constitutional provision or by the enforcement of any assessment or otherwise, all such liability being by the acceptance hereof and as part of the consideration for the issue hereof expressly released, as provided in the Consolidated Mortgage.

(Continued)
This bond shall not be entitled to any benefit under the Consolidated Mortgage, and shall not become valid or obligatory for any purpose, until it shall have been authenticated by the execution of the certificate hereon endorsed by the Trustee under the Consolidated Mortgage.

IN WITNESS WHEREOF, ANACONDA COPPER MINING COMPANY has caused this bond to be signed in its name of its President or one of its Vice Presidents, and its corporate seal to be hereunto affixed or imprinted and to be attested by its Secretary or one of its Assistant Secretaries.

Dated,

ANACONDA COPPER MINING COMPANY,

Attest:

Secretary.

(FORM OF TRUSTEE'S CERTIFICATE ON ALL BONDS)

THIS IS TO CERTIFY that this bond is one of the bonds of the series designated therein described in the within mentioned indenture.

GUARANTY TRUST COMPANY OF NEW YORK,

As Trustee,

by

565. Explanation and Comments.-- This plate is self-explanatory.
Third: Shares of Stock of Following corporations pledged under Agreement of January 2, 1919:
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1- Each of those articles in the Table of Contents is as detailed that shown above in pages 1-18.
It should be obvious from the above Table of Contents and from plates 183 and 184, that the importance and the intricacies of a deed of trust are such that the senior auditor must regard the abstracting of one as a task for himself, or at least for no-one less than a well seasoned semi-senior. Furthermore, the senior auditor ought personally to see that none of these indenture provisions are in default. If one or more provisions has not been fulfilled, the auditor will most certainly have to qualify his certificate in this respect, and, if a report is rendered, he must comment on the omission in as great detail as is necessary to set forth the facts clearly.

As the closing thought of this section, it is reiterated that too much care can not possibly be given to this portion of the audit; therefore, the senior auditor should reserve this investigation for himself.

567. See Plate 183.

568. See Plate 184.

569. Issuance.—Ordinarily, the auditor should completely verify the debits which accompany the credits to the Bonds Payable account, in order to ascertain what consideration the corporation received, and whether or not the proper entries were made to record such facts as the premium or discount, etc. In this connection the auditor should ascertain from the minutes that the issue has been formally authorized. In certain instances he should also satisfy himself that there are no provisions in any prior security issue which prevent bond issue. This latter investigation is hardly necessary, of course, if the legality, etc. of the present issue has been passed upon by a law firm and if the security-holders interested therein have not contested the bond issue. This word of precaution is more likely to be applicable in the case of an increase in the outstanding amount of an existing bond issue (open end).

Thus in a particular instance, for example, the auditor should see that the current ratio is at least as favorable as that required by the mortgage indenture before additional bonds of the same issue may be authenticated. The auditor should not proceed on the basis that everything must be all right if the Trustee has signed these additional bonds. As Trustees have been known to overlook certain provisions in the Deed of Trust, the auditor should merely regard the absence of protest by the Trustee as very strong evidence, not conclusive proof, that the additional bonds are within the provisions of the Deed of Trust.

When bonds are issued for property, the auditor should insist that the directors establish the values at which the various assets are to be brought on to the books of account. That is, the auditor should never undertake to do it personally. Naturally, it will be a very rare occasion indeed for the auditor to find that the property has been valued by the directors below the par value of the bonds issued in consideration thereof. Even so, it is not the auditor's duty to challenge the directors' values when in his opinion they are overstated. In the absence of fraud, the law gives the directors reasonable discretionary powers in such matters, because it fully recognizes that a piece of property can have totally different values even in the opinion of experts. Thus a certain business block may be worth only a comparatively small sum in the opinion of one expert realtor,

---

1. Sometimes the Trustee will not execute the additional bonds until the auditor certifies that none of the indenture provisions are in default.
AUDITOR'S EXCERPTS FROM A TRUST INDENTURE  PLATE 183

BALDWIN & BALDWIN, INC.
Excerpts From Trust Indenture
First Mortgage Bonds

Principal $6,500,000
Dated Jan. 1, 1929
Maturity Jan. 1, 1959
Interest Rate 7% per annum
Interest Payable Jan. 1, and July 1 at (Guarantee Trust Co. of Boston
Trustee Slater Trust Company, Providence, R. I.

SINKING FUND

Beginning Jan. 1, 1934 the Company is to pay the Trustee $250,000 per annum for the retiring of the outstanding bonds at not more than 101 and accrued interest to date of purchase. And a further sum is to be added by the company on June 1 of each year beginning June 1, 1934, such that the par value of the retired bonds and the cash on hand will at least equal $250,000 multiplied by the number of years after June 1, 1933, except that the final payment will be made on Jan. 1, 1959 and in a sum sufficient to retire all outstanding bonds.

When the Trustee cannot purchase bonds within the limitations noted, i.e. 101 and accrued interest, it must notify the Company which will call the necessary bonds by lot drawn in the presence of the Trustee. Bonds purchased or redeemed shall be cancelled.

PURCHASE IN OPEN MARKET

The Company may purchase as many of its own bonds on its own accord as it may desire with power to offer them at par to the Trustee in lieu of money payable to the Sinking Fund.

TRUSTEE'S COMMISSION

The Trustee is to receive 1/2 % on the par value of the retired bonds plus all expenses properly incurred in operating the fund.

NET QUICK ASSETS

Net quick assets are to be defined by the Company's certified public accountant. They must be equal to at least $3,000,000. Until such is the case no dividends on common stock may be declared or paid.

REGISTERING

The Bonds may be registered as to Principal only.

TAX FEATURES

(1) Federal Income tax not in excess of 2% per annum on interest payments paid by the Company.
(2) Massachusetts income tax not exceeding 6% of the interest received,

(Continued)
and the Pennsylvania property tax not exceeding 4 mills per annum on each $1 of face amount, will be refunded upon application to holders paying the same.

SALES OF PLEDGED PROPERTY

If the Company is not under any default whatsoever to the Trustee, it may sell any of the property (not exceeding $3,000,000 at values now on books) which in the Company's opinion is of no further use to it. The Company shall furnish the Trustee with a Certificate stating (1) that the property is of no further use, and (2) that the sales price is a fair one. The proceeds of the sale are to be placed with the Trustee to be invested by it in U.S. Government bonds. Said proceeds may be withdrawn in whole or in part by the Company upon presentation to the Trustee of a Certificate from its Certified Public Accountant to the effect that a similar amount has been invested in additional property, betterments, or improvements.

INSURANCE AND TAXES

All property covered by this mortgage is to be insured by the Company and the policies are to be deposited with the Trustee.
All taxes are to be paid by the Company.

567. Explanation and Comments.—This plate gives representative excerpts of a trust indenture. As can be seen by reading them, it is very important (1) that the auditor make such an abstract for his permanent file of working papers and (2) that he ascertain that these provisions have been fulfilled.
(1) A COPY OF A PROVISION ON THE MAINTENANCE OF CURRENT ASSETS

The Company covenants that it will not declare or pay any dividends upon its common stock if after the declaration and payment of such dividends the net current assets (as hereinafter defined) of the Company would be reduced to an amount less than the principal amount of all bonds issued hereunder and then outstanding.

As used in this Indenture the phrases "the net current assets" shall mean the amount remaining after deducting from the amount of current assets (as hereinafter defined) the amount of current liabilities (as hereinafter defined).

"Current assets" shall include the following:
(a) Cash on hand and in bank.
(b) United States Government obligations taken at their current market value.
(c) Other good and readily marketable securities, taken at their current market value.
(d) Good and collectible accounts, bills and notes receivable and trade acceptances received from customers in the ordinary course of business, not over sixty (60) days past due and maturing within one year from the date thereof; and also items of like character which mature within more than one year and less than two years from the date thereof; provided, that such last mentioned items maturing within more than one year and less than two years may only be included as current assets up to but not exceeding in the aggregate thirty-three and one-third per cent. (33-1/3%) of the total current assets under this clause (d) exclusive of such items maturing within more than one year and less than two years, and provided, further, that no such items maturing in more than one year from the date thereof shall be included as current assets unless payment of the same is adequately secured by pledge, mortgage, vendors' or other lien on products sold or on other property which itself would fall within one of the clauses of this definition of current assets.
(e) Inventories of raw materials and supplies, work in process and finished products taken at cost or market value (after reasonable deduction for obsolete machines or parts, if any) whichever is lower.

As used in this Indenture, the words "current liabilities" shall mean all the obligations and liabilities, due or accrued, maturing within one year and all such obligations and liabilities maturing in more than one year and not later than the date of the last maturing current asset then included by the Company under clause (d) of this Section; provided, that, obligations maturing in more than one year from the date thereof and secured by mortgage shall not be deemed current liabilities.

(b) A PROVISION ON COLLATERAL SECURITIES PLEDGED

"Now therefore, the Corporation in consideration of the premises and of one dollar ($1.00) to it paid by the Trustee, the receipt whereof is hereby acknowledged, and in order to secure due and punctual payment of said bonds and of the interest thereon, does hereby sell, assign, transfer, and pledge to, and agree forthwith to deposit with the party of the second part, Trustee as herein provided, and its successors in the Trust:

4000 Shares Capital Stock The West Carbide Company
2000 Shares $7 Cumulative Preferred Stock United Steel Corporation
4000 Shares $6 Series A Cumulative Preferred Stock Eastwood Oil Corporation
4000 Shares Capital Stock American Can and Box Corporation
1000 Shares Capital Stock Tuscan, Topeka and Santa Maria Soap Works

568. Explanation and Comments.--These two provisions are given in order to show that the importance of correctly abstracting the Deed of Trust, including the examination to ascertain that no provision is in default, is such that the senior auditor cannot afford to assign this work to anyone other than himself.
and yet have a substantial value in the eyes of a second expert realtor. The latter may believe, for instance, that the center of the downtown business area is going to swing decidedly toward the neighborhood of this block within the next few years. In brief, the law being such as it is, it is not the auditor's duty to challenge watered values established by the board of directors; but in his report the auditor must state that the values were established by the Board, the consideration being such and such an amount of bonds.

570. Retirement.—Whenever the client has personally bought any of its own bonds, the auditor should examine the brokers' vouchers, the cancelled checks, the bonds themselves including the unmatured coupons, if any, and the accounting entries. The bonds and coupons, if retired, should be carefully preserved, but mutilated to prevent their being reissued. One method of doing this is to have prepared a blank book whose pages are numbered to correspond with the bond numbers. On each page are printed numbered oblongs, one the size of the bond and the others the size of the coupons. As the coupons are redeemed and finally the bond itself, they are pasted in their respective quarters.

If cash payments are made to a Trustee, the cancelled checks should be examined, and the amounts should be traced into the periodic reports received from the Trustee. On the whole, it is advisable to carry these cash payments to the Trustee in a separate account until such time as the Trustee delivers the cancelled bonds, or a cremation certificate (Plate 185). The same procedure is also advisable in the case of the cash advances made to meet the coupon interest. Hence, there may be on the client's books cash on deposit with the Trustee (also the related liability) equal to the bonds and coupons not turned in to the client as yet by the Trustee.

571. See Plate 185.

572. See Plate 186.

573. The Trustees.—As has been indicated, a bond issue is often put out under the supervision of a Trustee, usually a Trust company, which represents the bondholders. In such instances the Trustee's signature must appear upon a bond in order to make it genuine.

As a part of his verification of the bond accounts, the auditor must request the client to have the Trustee send direct to the auditor a certificate stating the amount of bonds authorized, issued, retired, and outstanding as of the audit date. If there is a sinking fund, the client must also request that the certificate give the details of it (Plate 115 and 116).

At times, the Trustee's certificate and the books of account will not tally. If so, the difference is generally due to the omission of the entries based on the Trustee's last report. After having effected a reconciliation by bringing these entries on to the books, the auditor will naturally turn to an examination of the other reports of the Trustee. Indeed, this is the proper procedure even when no reconciliation has been necessary, for an audit of the bond accounts can hardly be said to be satisfactory and complete, even in a balance sheet audit, without such a verification.

574. See Plate 187.

——And the corporation too.
A FORM OF CREMATION CERTIFICATE  PLATE 185

SECOND TRUST AND SAVINGS BANK
CLEVELAND, OHIO

CREMATION CERTIFICATE

THIS IS TO CERTIFY, that we, the undersigned, have this day in the presence of each other, DESTROYED the following described Securities BY BURNING THE SAME TO ASHES.

For SECOND TRUST AND SAVINGS BANK

Dated Cleveland, Ohio

Witness to all signatures

571. Explanation and Comments.— If the Trustees does not give the client the cancelled bonds and coupons which it acquires for the sinking fund under the provisions of the Deed of Trust, it will give the client in lieu thereof a cremation certificate to the effect that such and such an amount of bonds and coupons of such and such an issue have been acquired and cremated in accordance with the provisions of such and such Deed of Trust, in testimony whereof the certificate is executed.
A NOTICE OF REDEMPTION PLATE 186

To the Holders of First Mortgage 5 1/2% Serial Gold Bonds of Jordan & Merrill, Inc.

Notice is hereby given in accordance with the provisions contained in Article two of the First Mortgage dated December 25, 1924 between Jordan & Merrill, Inc. and Pan American Trust Company of New York that Peabody, Jones & Company, successor to the rights and obligations of said Jordan & Merrill, Inc. under said First Mortgage has elected to redeem on the 23d day of December 1930 the whole of Series K, of Series L, of Series M, and of Series N of the above mentioned bonds then outstanding, at 102% of their principle amount with accrued interest to the date named for redemption, and that the interest on all of the bonds of said Series shall cease on said 23d day of December 1930. All of the bonds of said Series with all coupons due June 15, 1931 and thereafter attached, are required to be presented on and after said 23d day of December, 1930 to Central Bank and Trust Company, the agency of said Peabody, Jones & Company for the payment of said bonds, at its offices 71 1/2 Broadway, Borough of Manhattan, City and State of New York.

PEABODY, JONES & COMPANY
By F. S. Hawkins  
Vice-President

M. P. Tietze  
Secretary

Dated, Detroit, Mich. October 21, 1930

572. Explanation and Comments.--- This plate is self-explanatory.
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorized and Issued 2/1/26</td>
<td>5,000,000.00</td>
</tr>
<tr>
<td>Cancelled - 3 x $1,000,000 (par) per sinking fund provision</td>
<td>3,000,000.00</td>
</tr>
<tr>
<td>Balance 1/1/30 per G/L and our report</td>
<td>4,700,000.00</td>
</tr>
<tr>
<td>Retired during 1930 at 101 and accrued interest as per sinking fund provision (par)</td>
<td>X 1,000,000.00 (MM-1)</td>
</tr>
<tr>
<td>Balance 12/31/30</td>
<td>X 4,600,000.00 (MM-1)</td>
</tr>
</tbody>
</table>

**AUDIT PROCEDURE**

X Certificate attached MM-1 from bond trustee. See also permanent file, schedule 7, for Abstract of the Mortgage Indenture. See also schedule K on Sinking Fund. For accrued interest payable, see CC-2.

**BALANCE SHEET PRESENTATION**

Z Show $1,000,000 of this amount, which is due Feb.1, 1931, as a current liability, thus:

**FIRST MORTGAGE REAL ESTATE BONDS:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>(7% Sinking Fund Gold Bonds, due annually 1926 - 1976)</td>
<td>5,000,000.00</td>
</tr>
<tr>
<td>Authorized and Issued</td>
<td>5,000,000.00</td>
</tr>
<tr>
<td>Less - Retirements</td>
<td>400,000.00</td>
</tr>
<tr>
<td>Due Feb.1, 1931 - See above</td>
<td>1,000,000.00</td>
</tr>
<tr>
<td>Outstanding (after Feb.1, 1931)</td>
<td>4,500,000.00</td>
</tr>
</tbody>
</table>

574. Explanation and Comments.—This plate represents a simple schedule on bonds payable. However, it contains practically all of the essential elements of a complete clear-cut analysis sheet. Note particularly the comment on the balance sheet presentation.
575. **Bond Interest.**—The auditor should always tie-up the bond interest payments with the bonds payable account. Of course, even if the amount of the interest payment checks out satisfactorily, it is not conclusive proof that the bond liability is correctly stated. However, in the absence of fraud, it is a fairly conclusive proof.

If the client is holding its treasury bonds alive as investments, or in the sinking funds, etc., the amount thereof should be tied-in with the amount of interest received thereon as per the Interest Income account, or other interest income source.

In conclusion the following miscellaneous points are recalled to mind. (a) In some instances it may be necessary to recall that bond interest is just as much a lien on the pledged property as is the bond principal. (b) The auditor must carefully check the amount of the accrued current liability on bond interest, and also ascertain that the amounts due have been paid. (c) As has been indicated, the bond premium or discount account, as the case may be, must be adjusted via the bond interest expense account if the cash paid out as interest is charged in toto to this account. (d) When a bond must be redeemed at a premium, the amount of the premium should be accumulated by periodic charges to the bond interest account. (e) During a period of construction, a portion of the bond interest and discount (or premium) accounts are often proper capital charges (or credits).

576. **Coupons.**—As has been said, all redeemed coupons must be cancelled and carefully preserved, not destroyed. They should be pasted in their respective numbered compartments on the sheet whose number tallies with the bond number. If there is a Trustee, and if it has destroyed the coupons, the client must secure a cremation certificate to this effect (from the Trustee), and preserve it for the auditor's inspection. If the coupons are not destroyed, the auditor must test the coupon records in order to satisfy himself that they are in good order. If they are not in good order, the auditor should report the matter to the client, demanding that the coupons be sorted by the office force before the report is signed and issued. The auditor should never undertake to do this merely clerical work unless the client desires it. In rare instances the auditor's certificate may have to be qualifed in this respect, if the situation is not satisfactory to the auditor, for it should ever be remembered that some additional evidence in the nature of an assurance that the coupons (or bonds) cannot be reissued ought always to be seen in addition to the cancelled checks issued to the bond trustee in payment thereof. This procedure is identical with that used in auditing notes payable wherein the auditor examines the cancelled notes as well as the cancelled checks.

577. **Treasury Bonds.**—In accordance with the best usage of the term, treasury bonds are those bonds of the corporation which have been issued and reacquired through purchase, donation, etc. They are, therefore, distinct from unissued bonds. Of course, in some instances the distinction is negligible, whereas in other circumstances the technical difference is of paramount importance. Take, for example, a corporation which, prospering beyond expectation, redeems or purchases on the open market substantial amounts of its outstanding bonds in addition to those acquired.

In the case of bonds registered as to interest, the interest payment is made by check payable to the bondholder of record. Bonds are registered either with a Registrar or with the Corporation.
by the Trustee in accordance with the provisions in the Deed of Trust. Suppose further that this corporation strikes a financial snag at some later date and thereby becomes in need of additional working capital. The corporation certainly might congratulate itself on having on hand sufficient treasury bonds "to turn the trick", because these could be sold without any interference from the Trustee. On the other hand, suppose that this company does not have these treasury bonds but that the Trustee still has plenty of unissued bonds, (That is, the amount of the outstanding bonds is much less than the authorized amount of bonds.) Is it not easily conceivable that the corporation's position could thereby be entirely different? The Trustee, for instance, might refuse to authenticate these additional unissued bonds on the ground that the company's financial and/or operating condition, etc. does not now satisfy one or more provisions in the Deed of Trust. In brief, the technical difference between Treasury bonds and unissued bonds is, in such an instance, a real difference of paramount consideration to the corporation, and to the bondholders.

On occasions unissued bonds may be issued as collateral security to another form of indebtedness. If so, these bonds may be shown both as being issued and as being in the treasury, but pledged. But other than for this reason, or a similar one, unissued bonds are not brought on to the balance sheet even though they have been formally executed with seal and signatures. It may be explained here that the only reason why a creditor would ask for the pledging of one indebtedness as collateral security to another form of indebtedness would be to obtain the security inherent in the collateral. Thus a first mortgage bond is often acceptable security to an unsecured note payable.

If the treasury bonds are either going to be cancelled, or kept alive but not disposed of, they should be brought on to the books of account at par. This entry, requiring an adjustment from cost to par value, must take into consideration the portion of the Bond Premium or the Bond Discount applicable to these securities. The resulting charge or credit, as the case may be, should be to capital surplus if the amount is substantial, otherwise to earned surplus.

If it is the intention of the client to resell the treasury bonds, they may be entered on the books at cost, but on a balance sheet presentation they should be deducted at par from the outstanding bonds if the amount is substantial. Of course, if the client desires that they be shown as assets, the auditor must label them distinctly as Treasury Bonds. Their valuation and treatment as current assets should be the same as that accorded other temporary investments in securities (Soc. 329).

The treasury bonds which are on hand should be given the same careful examination that is given to other securities; i.e., they should appear to be regular in every respect in regard to the corporation's and the trustee's signatures, the corporate seal, the unmatured coupons, and so on. In addition, when they are kept loose and are not mutilated, even though they are not likely to be reissued, they should be accounted for by number (at least by tests) from period to period. If the bonds are legally prohibited from being reissued, they and the unmatured coupons must be

1 Undoubtedly the better procedure is to state the facts in a footnote.
cancelled, and, as explained, they should be kept in good order, such as by being pasted in a book especially designed for this purpose.

Treasury bonds and unissued bonds which are alive but which are not on hand should be confirmed by direct correspondence with the pledgees who hold them.

578. Independent Confirmation.—Unless there is a Trustee, it is not customary to verify the amount of the bond liability by means of direct correspondence. In fact, this procedure is impossible since the names and addresses of the individual bondholders are unknown. This is not true, of course, in the case of the registered bonds, which, if there are any, are generally only a small portion of the total issue. Moreover, there is usually no need to question the amount of the bond liability unless something is wrong. If the amount authorized, or the amount authorized to be issued at one time, can be accounted for through the proceeds thereof, through the unissued bonds on hand assuming none are out as collateral, through the amount of the periodic interest payments, etc., and if the purchases can be verified by cancelled checks, brokers' vouchers, security count, etc., the reasonable assumption is that the balance of the bond liability account is properly stated. Furthermore, the auditor should remember that there is undoubtedly on hand somewhere in the client's office enough independent collateral information sufficiently satisfactory to clear up all ordinary evidence of discrepancies, if any should arise.

If feasible the public records should be examined.

579. Balance Sheet Presentation.1—As has been noted, treasury bonds should be subtracted2 at par from the outstanding amount, or stated as Treasury Bonds at values applied to temporary investments (Sec. 329) if shown as assets. This latter presentation, to reiterate, is not desirable unless the amount of bonds is small and unless they can and may be disposed of. In all such instances a full disclosure of the kind of bonds and the par amount of them must be made.

Uncovered serial installments should be shown as current liabilities if they become due within a few months3 after the date of the balance sheet.

1-Attention is again directed to the fact that a footnote should be made on the balance sheet as to the properties mortgaged, or where feasible the mortgaged assets should be set forth separately on the face of the statement. This is the goal of a proper presentation, but few balance sheets, it may be noted, give these facts.

2-Some auditors favor subtracting the Sinking Fund from the Bonds Payable.

3-It is a frequent practice to include within current liabilities redemption payments due within the succeeding twelve months and other similar requirements, although they constitute no theoretical lien against the existing current assets and will, in normal circumstances, be liquidated out of funds to be produced by the operation of the ensuing period. Bond-redemption payments, in particular, are frequently related to depreciation and constitute the equivalent of an actual investment of reserved depreciation. A bond-redemption payment due at the end of a year may and frequently does represent the amount to be realied during the year through depreciation or depletion included as an operating cost. Timber bonds, the redemption payments of which come out of stumpage cut, constitute a particularly clear case. In such and similar instances the inclusion as a current liability of all bond redemption payments due within a year is unwarranted by any theory. It is the equivalent of including as a current liability the indebtedness for a bill of goods and excluding the goods as a current asset. If they must be included, would it not be correct to include as a current asset the amount of depreciation or depletion to be realized during
sheet. Under the same circumstances, the same treatment should be accorded the whole of a matured bond issue, except that if the debt is to be renewed, assuming that in fact it can be renewed if desired, it may be shown in its usual position as a long-term debt. Even if the auditor is in doubt as to the possibility of its being able to be renewed, no violation of good accounting procedure is committed if the auditor should give expression to the client's intention and belief by continuing to show the liability as a long-term debt, provided the maturity date and all other essential particulars are given in full on the balance sheet.

On the other hand, if the bonds are truly funded, the fund of assets (if it is not treasury bonds) may be listed as a current asset, provided the indebtedness is designated as a current liability. Usually, however, it is better to leave a maturing FUNDED (covered) issue and its sinking fund alone in their original "fixed" positions.

Within reason the fullest possible description of a bond issue should always be given on the balance sheet, even if it necessitates a footnote. Included therein should be the maturity date, or dates if serial, the interest rate, the nature of the property pledged, the amount of bonds authorized, issued, in the treasury and pledged, the possibility of conversion into stock, and so on. If a report is also rendered, the comment therein on bonds must be clear and complete, because space is not now of any essence of the matter.

Bond Discount may be deducted from the liability account.

580. See Plate 186.

581. See Plate 189.

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A. Herrick, The Journal of Accountancy, Jan. 1932 (p. 54)


The current balance sheet, dated December 31, 1930, shows outstanding bonds of the amount of $18,813,000 and does not reflect the calling of the above mentioned $5,000,000 bonds redeemed as of January 1, 1931, which will be given affect in the balance sheet of the coming year."—Report of Board of Directors of The American Sugar Refining Company.

The BOND DISCOUNT account is a valuation account; however, it is usually looked upon as a prepaid cost of capital and is placed, therefore, under the main caption, DEFERRED CHARGES TO OPERATIONS.
FORMS OF BALANCE SHEET PRESENTATION OF BONDS PAYABLE

(a) DEBENTURE NOTES (6 1/2%, due annually 1920-40):
Authorized and Issued $2,000,000
Less - Retired through Sinking Fund 100,000
Outstanding 1,900,000

(b) FIRST MORTGAGE REAL ESTATE BONDS:
(6% Sinking Fund Bonds, Due 1930, Authorized $3,000,000)
Issued $2,500,000
Less - Held to Redeem Outstanding 7% Bonds 1,500,000
Held by Sinking Fund Trustee 100,000
Outstanding 900,000

(c) REFUNDING FIRST MORTGAGE 6% BONDS, DUE 1940:
Authorized and Issued $1,000,000
Less - Held in Treasury:
Unpledged 100,000
Guaranty Deposit with the City of Cairo, R.I. 300,000
Outstanding 600,000

(d) EQUIPMENT TRUST 5% BONDS, DUE 1930:
Authorized and Issued $500,000
Less - In Treasury, Pledged to Secure Notes to Banks 500,000

(e) COLLATERAL TRUST, 5% BONDS, DUE 1930:
Authorized and Issued $500,000
Less - In Sinking Fund, including Cash 70,000
In Treasury, Pledged to Secure Notes to Trade 100,000
Outstanding 170,000

(f) PURCHASE MONEY MORTGAGE, 6%, DUE 1940:
Original Balance $200,000
Eight Annual Payments at $10,000 each 80,000
Ninth Annual Payment, Due January 15, 1929 Net $120,000
10,000 110,000

580. Explanation and Comments.--As stated in the text, the fullest possible
description of a bond issue should always be given on the balance sheet even if
it necessitates a footnote. Included therein should be the maturity date or
dates if serial, the interest rate, the nature of the property pledged, the
amount of bonds authorized, issued, in the treasury, and pledged, the possibil-
ity of conversion into stock, and so on. If a report is also rendered, the
comments therein on bonds must be clear and complete because space is not now
of any essence of the matter.

Also, note that treasury and/or unissued bonds are often used as collateral
security for an unsecured liability such as a note payable - bank, or a note pay-
able - trade.

("Mr. Kirshenberg: With sterling at 3.80(par 4.66) on a $6,000,000 mortgage
liability, the majority of which is due after a year, there would be an exchange
profit of about a million dollars, which would be picked up in current opera-
tions as a profit. To my mind, seeing that the property was carried at cost
(4.66), and that the property has not been paid for as yet, I believe that any
profit that may arise, due to exchange fluctuations, should be considered as a
deduction from the original cost of the property.

"Mr. Gray: I think that is a good answer.") -- "Relations Between Account-
ants and Bankers"—N.Y.S.S. of C.P.A., Nov. 1931 (p.21)
22. BONDS PAYABLE (1st Mtg. 6's -1940, and Collateral Trust 7's - 1950)

1. Abstract the Deed of Trust - Collateral Trust 7's
2. Ascertain from the Minutes the amount of collateral trust bonds authorized, etc., etc.
3. Prepare schedules like GG in last year's papers.
4. Tie-up the bond interest expense accounts with the bond accounts.
5. Obtain from the Trustees, Certificates like GG-1.
   They must contain:
   (1) "Amount of bonds authorized
   (2) " " " issued
   (3) " " " outstanding
   (4) " " " called
   (5) " " " redeeming in the past
   (6) " " " during current period
   (7) " " " called but not redeemed,
   (8) " " " own bond, purchased for sinking fund
   (9) " " " cash and description securities in sinking fund
   (10) Statement that no provision is in default.
   (11) Detailed statement of collateral held.

6. Check the trustees' interim reports to the books of account.
   See cremation certificates for retired principal and coupons.
7. Examine the Record of Registered Bondholders.
8. Check the amounts of accrued bond interest payable.
9. Verify by correspondence any treasury bonds which have been pledged.
10. Analyze and verify in detail the credit and debit entries in the bond accounts. See that the proceeds were actually received. See that the reductions are genuine. See that the discount (or premium) on original issues has been properly handled.
11. Ascertain how the proceeds from the collateral trust 7's have been used. Is it in accordance with the provisions of the bond?
12. Tie-up the bond interest received against any treasury bonds which are held. Do not treat as income.
13. Examine the uncancelled treasury bonds on hand which are held as temporary investments or otherwise.
14. See that the discount (or premium) on retired treasury bonds has been properly cancelled.
15. See that no provision in the deeds of trust is in default.
16. See that discount (or premium) has been properly amortized.
17. Examine the cancelled coupons and bonds. See that they have been pasted into the bond register.
18. Do not absorb profit arising on bonds payable in foreign currency. The present depressed rates of exchange will not
18. (cont) likely exist at the maturity date.
19. Examine the listing application.
20. Examine the agreement with the underwriter as to selling price, commission, expenses, etc.
21. Bonds authenticated but unsold should not be shown as an asset.
22. See that the income on sinking fund cash and securities has been handled as prescribed by the bond indentures.
23. Treat as a current liability any serial payment falling due within a year, if there is no sinking fund cash available to retire it.
24. Show as current liabilities bonds called for redemption (by the audit date) but not redeemed.
25. Verify premiums paid on called bonds against the provisions of the bond indenture.
26. See that the provision as to insurance has been carried out as an infraction may cause a technical maturity of the bonds.
27. See that the proceeds (if any) of sale and/or fire insurance on pledged property is properly applied as provided in the bond indenture.
28. Check the propriety of any substitutions of collateral.
29. See that sufficient authorized preferred stock is on hand to cover all possible calls under conversion privileges.
30. Make the balance sheet presentation very descriptive and complete in every possible respect. See last year's presentation.
31. Capital stock surrendered for conversion into bonds should be on hand and properly cancelled, or evidenced by cremation certificates.
32. When coupon bonds may be registered, examine those turned in. See that they are properly cancelled, or evidenced by cremation certificates.
33. See if any stock provisions prohibit the issuance of the collateral trust bonds.
34. Where the records show bonds registered in the name of the corporation or the treasurer of the corporation as such, compare such records with the treasury bonds on hand and with the amount as shown in the "Treasury Bonds" account.

591. Explanation and Comments.--This plate shows the bonds payable section of an audit program. The instructions apply, where applicable, to each of the two bond issues. The first mortgage bonds were issued in 1900, whereas the collateral trust bonds are being issued currently.
REVIEW QUESTIONS

1. Draw up and fill in an analysis sheet whose heading is: "Abstract of Trust Indenture—First Mortgage 7's Due 1950"

2. What is a collateral trust bond? What is a debenture bond?

3. Give a reasonable illustration showing how the premium on an issue could be properly handled.

4. Do the stockholders have to give their consent to a new bond issue, or can the directors negotiate this loan without referring the matter to the stockholders?

5. Give in technical wording a provision that might be found in a preferred stock which would prevent a bond issue under certain circumstances.

6. Draw up an Auditor's Certificate qualified in some respect because of a default in a provision of a deed of trust. Also give the exact wording of the provision of the deed of trust and state wherein it is in default.

7. Distinguish between a deed of trust and a bond.

8. By means of a Table of Contents state some of the usual provisions to be found in deeds of trust.

9. During the year under audit, the Trustee has authenticated $250,000 (par value) worth of bonds. Should the auditor assume that since the Trustee has not objected to the new bonds every thing is all right, or ought he to satisfy himself on this point by independent inquiry and examination?

10. To whom should be assigned the task of abstracting the deed of trust? Why? To whom should be assigned the task of seeing that the provisions of the deed have been fulfilled? Why?

11. Why isn't it the duty of the auditor to challenge the watered valued (if any) of property purchased by bonds?

12. When may a bond be registered? What are the advantages and disadvantages thereof? Can a bond be registered as to interest?

13. What comments should the auditor make in his report when property has been purchased with bonds?

14. What are the three most common types of security in back of bond issues?

15. Name seven types of reasons why corporations issue bonds.

16. Why should the auditor insist that the board of directors establish the values of property bought for a lump sum?

17. Why is it uncommon for single proprietorships and partnerships to issue bonds?

18. If the client has personally bought some of its own bonds, what should you examine in proof thereof?

19. What is the function of the bond trustee?

20. What information would you as auditor request of the Trustee? Give your answer in the form of a letter to the Trustee.

21. Distinguish between the treasury bonds and unissued bonds.

22. If the treasury bonds are not going to be reissued, should they be mutilated? Why?

23. Under what conditions would you recommend the showing of treasury bonds as an asset?

24. What is the method outlined in the text for keeping the retired bonds and/or coupons in good order?

25. In a balance sheet audit would you consider it necessary to check the Trustee's reports into the books of account? Why?

26. Why must the auditor see that the redeemed coupons are in good order?
27. What should the auditor do if the redeemed coupons are not in good order?

28. Should treasury bonds which are shown as assets be treated and valued as current assets or as fixed assets? Why?

29. How should serial bond installments (payable) be shown on the balance sheet?

30. How would you audit the cash payments made to the Trustee?

31. Why is it impossible to verify the total bond liability by means of independent confirmation with the individual bondholders?

32. On an audit as of December 31, 1930, you ascertain that the bond issue of $1,000,000 will become due on June 30, 1931. The client expects to be able to renew it, but you are not so hopeful. The client asks you to continue to show the liability as a long-term indebtedness. What position would you take on this matter?

33. Criticize fully the following:

6 1/2% SERIAL GOLD NOTES (maturing in 15 annual installments from Mar. 1, 1926 to Mar. 1, 1940)

| Less-installments paid | $30,000,000.00 |

34. Criticize fully the following:

REFUNDING MORTGAGE 6% BONDS:

| Authorized # |
| Issued |
| Retired | $1,224,000 |
| Pledged to secure 6 1/2% |
| Serial Gold Notes | 1,400,000 |
| Treasury Bonds | 1,400,000 |

| Outstanding |
| $21,276,000 |

(# Amount unlimited but issue of further bonds subject to restrictions specified in the mortgage)

35. Do you agree with the answers given to the following question? If not, why not?

"Question:-- What is the correct method of accounting for the 'fixed charges' in the following situation--

"A 'vertical' merger or combination of pulp and paper mills and timber holdings owns timber limits greatly in excess of the requirements of its present mills. The timber holdings were acquired to assure the raw materials for possible future developments and to prevent their acquisition by competitors. The corporation has outstanding bonds, secured not only by the mill properties but by the timber limits. Consequently the 'fixed charges' for bond interest, taxes, etc., are much greater than would normally be found in either pulp or paper mills.

"Should these fixed charges be charged against the current operations, thereby showing results which are abnormal, or should such a portion of the charges as may be ascribable to the excess timber holdings be capitalized? To capitalize the charges might appear to be inflating the assets, but there is a normal natural increment of timber through growth and also there is an increasing value of stumpage through depletion.

---

1928 Annual Report of U. S. Rubber Company

21928 Annual Report of International Paper Company
"Answer No. 1--Unless the company is devoting money and effort to the planting, care and development of its timber reserves, we think there would be considerable doubt as to the propriety of capitalizing a portion of the fixed charges or of attempting otherwise to reflect the estimated annual growth in the capital-asset account. While we understand it is the practice of some companies to capitalize taxes, insurance (if any) and expenditures for the care and safeguarding of reserve properties, the capitalization of such items is always subjected to the limitation that the original cost together with the carrying charges should not exceed the market value of the property. We think it is usually considered that a stand of virgin timber does not increase in quantity through growth inasmuch as any growth of young trees is offset by the decay of matured trees.

"Your correspondent's letter further states that 'the corporation has outstanding bonds secured not only by the mill properties but by the timber limits; consequently, the 'fixed charges' for bond interest are much greater than would normally be found in either pulp or paper mills.' As will be observed from this quotation, your correspondent does not say that any of the bonds were issued for the acquisition of the timber reserves. We think it would be quite improper to capitalize so-called 'constructive interest' if the properties were acquired by an issue of capital stock or for cash derived from the sale of capital stock. While there might perhaps be some justification for capitalizing interest paid on interest-bearing obligations issued in payment for reserve properties, it would also be subject to the limitation already mentioned.

"The proper accounting treatment of the 'fixed charges' will depend largely upon the special circumstances surrounding the particular company, including those arising either from the provisions of the indentures or from company's financial policies in the depletion and replacement of properties, sinking funds, dividends, and distributions from depletion reserves.

"Answer No. 2.--In our opinion it would be permissible from an accounting standpoint to capitalize that portion of interest paid on bonds which is fairly apportionable to the timber holdings held for futuro requirements, together with taxes assessed upon said holdings, provided, however, that the capitalization of these fixed charges be limited to such a sum as will not result in an abnormal stumpage charge when the timber is ultimately cut.

"We would, however, direct the attention of the inquirer to the fact that from the standpoint of federal taxation there is considerable doubt as to whether carrying charges can be capitalized and included in 'cost' for purposes of computing depletion and gain or loss on sale of the timber holdings. It would therefore appear to be advisable to deduct in the federal tax return of the corporation owning the excess timber holdings all interest and taxes paid regardless of their treatment in the accounts of the company.

"Answer No. 3.--We can hardly see any justification for capitalizing any part of the fixed charges for bond interest, taxes, etc. To do so would create a situation that would be highly artificial. On the other hand it would seem to be proper, if desired, to make some statement in the income account that would show to what extent charges against income for bond interest, taxes, etc. represent carrying charges on the non-productive property."

CHAPTER 38

THE VERIFICATION OF CONTINGENT LIABILITIES

582. General Discussion.

583. Definitions and Explanations.

584. Explanation of Plate 190.

PLATE 190 - A Form of Client's Certificate on Contingent Liabilities.

585. Notes Receivable Discounted.

586. Judgments and Suits.

587. Accommodation Indorsements.


589. Acceptances.

590. Explanation of Plate 191.

PLATE 191 - A Unified Client's Certificate.

591. Leases.

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593. Purchase Commitments.


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597. Insurance Taken Out in Mutual Companies.

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606a. Audit Program.

Review Questions.

582. General Discussion

As has been emphasized herein before, the successful auditor is one who realizes that it is as often true as not that the most important facts to be ascertained on an audit are those which are not on the books of account. In this connection Lord Justice Lindley has said, "His (the auditor's) 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." 2

The above introductory paragraph is often nowhere more applicable than in the case of contingent liabilities. These items, rarely ever, entered on the books of account for fear of its being taken as an admission of a definite liability, are at best difficult to ascertain, and are well nigh impossible to uncover if the management really wants to conceal them; and yet the audit may be but a hollow shell of real accomplishment, "an idle farce" to use the words of the learned justice, if they are not found, examined, and intelligently reported on.

Because of their elusiveness and their importance, it behooves an auditor to be on the "qui vive" at all times for contingent liabilities. He must watch for them while reading contracts, deeds of trust, capital stock provisions, minutes, and so on. He must also be alert to uncover them during his audit of the accounts, or during a conversation with an officer, the

1 See Appendix C, Sec. 6-#4.
2 In re the London and General Bank (Accountants Law Reports 2 Chancery 166 (1895), page 172).
company's attorney, or an employee. Likewise, he must be certain to question creditors and others on this matter when getting their certificate principally on some other point, as when, for example, a certificate on the bank balance is being requested of a bank. Finally, he must never overlook getting the client's certificate thereon (Plate 190).

583. Definitions and Explanations1—The following dictionary definitions of "contingent" are suitable for our purpose: (1) reasonably likely or liable to occur, and (2) dependent on something uncertain or unsettled. Montgomery says, "The term contingent liabilities indicates the effect of acts or conditions prior to the date of the balance sheet which may become actual liabilities after that date."2

For convenience, contingent liabilities may be divided into two classes; namely, (1) those which are offset by contingent assets, and (2) those which are not thus offset. Another way of stating this situation is to say that the first group are secondary obligations, whereas the second group are primary obligations. That is, in the first group no liability exists unless and until the primary obligor defaults. The latter then becomes the debtor of the secondary obligor who has been forced to pay off the indebtedness. In the second group, the liability is direct and cannot be recouped from another. It constitutes a sheer loss to the payer.

The first group includes, among others, the following items:

(1) Discounted notes and acceptances receivable.
(2) Accounts receivable sold with a guaranty.
(3) Unused letters of credit.
(4) Guarantees of payment of interest and/or principal of the bonds of another company, such as a subsidiary or affiliated company.
(5) Accommodation endorsements for total outsiders.
(6) Liability under Purchase Commitments.
(7) Liability on the unpaid portion of stocks owned but not fully paid for.
(8) Indorsement of notes for affiliated and/or subsidiary companies.

The second group includes, among others, such items as:

(1) Guarantees of product or services.
(2) Assumption of mutual liability under fire and other insurance policies taken out in mutual companies.
(3) Unpaid accumulated dividends on cumulative preferred stocks.
(4) Liability under possible adverse judgments arising out of pending law suits on such matters as alleged patent, copyright, and/or trade-mark infringements.
(5) Assumption of liability to additional assessment under the double liability feature of bank stocks, etc.
(6) Liability under possible judgments arising out of pending law suits arising from alleged failure to fulfill leasehold agreements, contracts, guarantees, etc.
(7) Unsettled assessments for additional taxes by national, state, or local authorities.

From the nature of the above items, it should be clear to the reader that contingent liabilities are distinctly different from liabilities which are definitely known to exist, but whose exact amount is as yet unknown. This latter type of liability must be shown on the balance sheet as a true liability, even though the amount thereof is admittedly only an imperfect estimate. Indeed, it must never be forgotten that many balance sheet items are largely an expression of export opinion and estimates, rather than of definite ascertainable facts.

1 See the definitions and explanations at the end of this chapter.
2 Montgomery, page 293.
When the exact amount of a true liability is not definitely known, the estimated amount thereof is set up among the current or fixed indebtedness under some such caption as Provision for (name_of_item). On the other hand, contingent liabilities are usually stated in explanatory footnotes on the balance sheet. Common exceptions to this procedure occur whenever the contingent liability if of the type which is offset by a contingent asset. In such instances the best practice is to include the contingent asset in with the regular assets of the same category, and deduct the contingent liability therefrom. A third method, generally favored by banks, is to treat the contingent asset as a real asset and the contingent liability as a real liability. Finally, a fourth method is to state the contingent liability as a memorandum among the class of real liabilities in which it would be placed if it became a real liability.

584. See Plate 190.

585. Notes Receivable Discounted. Undoubtedly the most common form of a contingent liability is notes and acceptances receivable under discount. In order to show the maximum contingent liability on these items, the interest (if any) accrued to the maturity date, should be shown added to both the Notes Receivable and to the Notes Receivable Discounted accounts, or included in the amount stated in the balance sheet footnote. Of course, where the amount of interest is small, such a procedure is superfluous.

The possibility of there being unrecorded notes and acceptances receivable under discount at the banks, including the verification of those known to be under discount, should always be checked by making an inquiry thereon in every confirmation letter sent to the banks in connection with verifying other matters, such as the bank balances, the amount of outstanding notes payable-banks, etc.. If any notes have been discounted elsewhere, for example with a creditor, they also should be verified by independent confirmation.

If the client keeps a complete notes receivable register and/or a notes receivable discounted account, the auditor's task of verifying this contingent liability is greatly lightened. In fact, if these aids are not in use, the auditor should consider the advisability of suggesting that they be installed.

The provision for bad debts must always be sufficient to take care of possible losses on notes and acceptances under discount. Therefore, these notes and acceptances should be examined, aged, and judged with exactly the same care as that given to those on hand. This is a point that is apt to be overlooked.

"Notes receivable discounted which, between the date of closing and the end of the audit, have been dishonored are current liabilities."

586. Judgments and Suits. If (as stated in section 534) an auditor is equipped to do so, he should examine the public records for judgments entered against his client. These may be ample evidence that many others, arising from the same or similar source of legal action, will soon be secured against the client. If the auditor is not equipped to make this search, he may deem it advisable to secure the services of a lawyer. At the present time, however, good auditing procedure does not require the

Even discounted drafts drawn by a subsidiary on its parent company while not likely to be dishonored, must be noted. Thus the wording could be: "As at (audit date) the company had under discount notes receivable drawn on The (Parent Co.) Corporation in the amount of $_ _ _ _ _ _ __."
Messrs. Jordan and Merrill,
Certified Public Accountants,
Pawtucket, Rhode Island

Dear Sirs:

In connection with your annual audit of our books of account as at ______, we submit at your request the following certificate with respect to the contingent liabilities of the Company at said date.

We Hereby Certify that this Company is not a guarantor or indorser of any liabilities or obligations of any individual, firm, or corporation; it is not liable under any contracts, bonds, or profit-sharing arrangements or any other agreements; there are no lawsuits pending; and there are no contingent liabilities whatsoever except as set forth below.

Moreover, there have been no special matters occurring during the period under audit insofar as we the officers of this Company have knowledge, which would have any bearing on your report, and there have been no shortages or irregularities which have already been closed or which are now in abeyance. There are no suspicions or matters of a personal nature reflecting on the honesty of the members of our organization insofar as we have any information.

Full details of the following are attached hereto.

<table>
<thead>
<tr>
<th>Contingent Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Upon customers' notes and acceptances discounted, sold, or otherwise transferred.</td>
<td></td>
</tr>
<tr>
<td>Upon sight drafts treated as cash</td>
<td></td>
</tr>
<tr>
<td>Upon accounts receivable sold with a guaranty</td>
<td></td>
</tr>
<tr>
<td>For guarantees</td>
<td></td>
</tr>
<tr>
<td>For accommodation indorsements</td>
<td></td>
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<tr>
<td>Upon unused letters of credit</td>
<td></td>
</tr>
<tr>
<td>Upon leases</td>
<td></td>
</tr>
<tr>
<td>Upon purchase commitments</td>
<td></td>
</tr>
<tr>
<td>Upon bonds or other obligations of affiliated or subsidiary companies</td>
<td></td>
</tr>
<tr>
<td>Upon pending lawsuits</td>
<td></td>
</tr>
<tr>
<td>Upon agreements</td>
<td></td>
</tr>
<tr>
<td>Upon assumption of liability for unpaid stock subscriptions</td>
<td></td>
</tr>
<tr>
<td>For unpaid accumulated dividends on cumulative preferred stocks</td>
<td></td>
</tr>
</tbody>
</table>

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584. Explanation and Comments.—As explained in the text, the auditor must always audit the client as well as the books of account. One of the most important aspects of an audit to be covered in this manner is the contingent liabilities.

From the contents of this plate the reader should be able to see that this inquiry covers matters of the greatest importance to an adequate and accurate picture of the financial and operating condition of the company.

1Do not leave blank spaces. Write "None" in each such instance.
auditor to make a search of the public records, it being permissible for him
to rely upon other evidences on hand, such as inspection of the minutes,
and/or evidences that judgments are or will be entered against
the client. Moreover, the auditor should always get the attorney to sign
the client's Certificate on Contingent Liabilities (Plate 190).

In many instances the auditor should remember that the amount of a
suit is not likely to be the amount of the damages awarded, assuming that
it is conceded that the case will very likely be lost by the client. Furthermore, he should remember that the decision rendered in a lower court is not final. In brief, the auditor, in attempting to make a satisfactory audit,
must not become too dogmatic as to how the situation must be set forth. As a rule the liabilities are too contingent to be embodied in the accounts. Reference to them will usually take the form of a brief but descriptive footnote, the report giving a full account thereof. If a report is not rendered, the balance sheet footnote must be very complete. In this connection the writer feels called upon to remark that too many auditors show, by the lack of real vital information in their footnotes, that they regard "putting on notice" as the equivalent of "giving information." The two may be essentially the same in the case of bankers and other similar parties who can demand the information they want, but it certainly is NOT true of most stockholders or the general investing public.

587. Accommodation Indorsements.—If a business becomes the primary
obligor via an accommodation indorsement, the proper accounting entry is a
charge to the accommodated business and a credit to notes payable. On the other hand, if the liability is only secondary, the credit should be to the
Indorser's Liability, or the facts may be set forth on the balance sheet in
a footnote. In the first instance, the liability is direct and full, and, as such, must be shown as an ordinary note payable. In the other case the liability is contingent and may, therefore, be set up either in ledger
accounts or in a balance sheet footnote.

The assumption that the contingency on an accommodation indorsement is extremely remote is not warranted by the actual number of defaults. It should ever be borne in mind that most firms which secure an accommodation indorsement are not in A-I condition.

When an accommodation indorsement has had to be met, the charge to
the accommodated party must not be assumed to be a good receivable. In
many instances it is nothing more or less than a bad debt. Therefore, it
must be evaluated when considering the adequacy of the reserve for bad
debts.

"An examination of the source of the supplies of the company and
its purchasing policy may disclose" that the client has endorsed notes of
the producer in order that it may obtain a line of credit during its
"growing or developing period."

588. Guarantees of Product and Services.—Practically every business
guarantees in some respect, either expressly or impliedly, its product and/or
its services. As wholesalers and retailers can usually fall back on the
manufacturer to settle any claims brought against them by the plaintiffs,

1Reread "In re The London and General Bank", sec. 46.
the topic under consideration is largely limited to manufacturers and/or original producers.

No rule of thumb can be laid down for the guidance of the reader with regard to the proper treatment of contingent liabilities. On each occasion the auditor must exercise his best judgment. However, there can be given at least three clear-cut "working" divisions into which guarantees can be resolved.

First, there are those guarantees for servicing the product gratis. These may remain in force anywhere from a few months to the whole lifetime of the product. In many instances such guarantees are expected by the guarantor to run into considerable money. As the cost thereof has been included in the original selling price, the client should charge a suitable expense account and credit a liability account (Plate 18). The amount should be based on the number of units sold or some other equally sound basis. In such instances the auditor's difficult duty is to satisfy himself that the adjustments are being handled properly, and that the final balance in the account is adequate.

A second division provides for those cases where it is known that the materials or manufacture of a certain batch, run, or series, etc. of a product is so faulty that customers are "raising the roof" about it. If the policy of the business is to make large allowances, or even take back the product in order to preserve its goodwill, a liability account must be established sufficient in size to absorb the expected losses.

The third division concerns itself with those general guarantees which may result in claims, but which the company never expects will arise in any considerable volume—which expectation experience shows to be justly founded. Take, for example, the following warranty: "We warrant the automobiles manufactured by us to be free from defects in material and workmanship under normal use and service, our obligation under this warranty being limited to making good at our factory any part or parts thereof which shall, within ninety (90) days after delivery of such automobile to the original purchaser, be returned to us with transportation charges prepaid and which our examination shall disclose to our satisfaction to have been thus defective.

"This warranty is expressly in lieu of all other warranties expressed or implied, and of all other obligations or liabilities on our part, and we neither assume nor authorize any other person to assume for us any other liability in connection with the sale of our automobiles.

"This warranty shall not apply to any . . . . Six automobile which shall have been repaired or altered outside of our factory in any way so as, in our judgment, to affect its stability or reliability, or which has been subject to misuse, negligence, or accident.

"We make no warranty whatever in respect to tires, rims, ignition apparatus, tops, upholstery, horns or other signaling devices, batteries, speedometers, or other trade accessories."

In such instances as the above, there is always an outstanding contingent liability. Some small adjustments will always have to be made with customers, but they are usually so negligible as not to warrant even a balance sheet notation on it, much less a liability account. However, exceptions to these last assumptions do arise occasionally. At such times these seemingly harmless warranties give rise to major losses.

569. Acceptances.—It is quite customary for a purchaser to arrange with its bank to accept drafts drawn by it in favor of the seller (Plate 163), or drawn under a similar plan. If the arrangement is completed, the seller can immediately get his money by discounting the accepted draft at his own bank. The transaction can now be regarded as closed because the acceptance
is a liability of the bank as well as of the buyer. A banker's acceptance, it may be explained, is always looked upon with considerable favor. This situation is reflected by the fact that the discount rate for banker's acceptances is usually lower than that for ordinary commercial paper.

On the other hand, if the seller's draft is accepted by the buyer only, it becomes a contingent liability of the seller alone when he discounts it at his bank.

The difference is that in the case of the banker's acceptance, the bank must pay it at maturity, even if the buyer should fail to give the bank the funds to meet it. As the credit standing of a bank or banker is assumed to be impeachable, the contingent liability of the seller is nil. That is, there is little likelihood that the bank will default and thereby force the seller to redeem the dishonored note from his own bank where he discounted it.

At this time a digression will be made to reiterate a point which was made in the chapter on inventories and in the chapter on notes and acceptances receivable.

It should be evident from the above that it is quite common for a buyer to get its bank to accept drafts drawn against it, if they are accompanied by bills-of-lading. By previous arrangement the buyer can often give the bank a receipt in exchange for the bills-of-lading. By this arrangement the buyer has gotten possession of the goods and yet he has not been obliged to make any record of them or of the liability therefor in his books of account. Of course, when he pays the banker the money with which to meet a draft, usually one day before the maturity thereof, he is obliged to enter the purchase invoice, but not until then. As the buyer is bound by contract to pay the bank for the goods, irrespective of the changes in market price thereof, it is obvious that the merchandise and the liability therefor must be shown in the books of account not later than at the time when the bank accepts the draft and the goods are enroute. If the entry is omitted at this time, extremely vital information has probably been suppressed because it often has a tremendous bearing upon the current position of the company.

In order to uncover this type of omission, the auditor must compare the order and receiving records with the purchase invoices; the entries on the creditors' monthly statements must be test-checked with the entries in the corresponding trade-creditors' accounts; bank charges particularly must be analyzed as to the reason for their existence; and the customary confirmation letter sent to the bank in regard to the bank balance, etc. must always make inquiry on this point.

590. See Plate 191.

591. Leases.—If the client holds a distinctly UNFAVORABLE long-term lease, there may be a definite contingent liability involved therein which is worth while mentioning. That is, if the client should move, an unrecorded liability would arise out of the breaking of the lease or the subletting of it at a smaller rent. It seems, therefore, that at least two conditions are usually necessary before this type of contingent liability (or loss) needs to be recognized. First, the market value of the lease must be considerably less than the book value, or the periodic rent called for by the terms of the lease must be much higher than current rates for a similar location; and second, the business must contemplate moving or at least see the possible

Of course, in extreme depressions (1931-33), there is a REAL contingency even for (certain) bank acceptances. For example, 2290 banks closed in 1931.

The Client's Certificate must also cover this point.
590. **Explanation and Comments.**--Throughout this text a number of Client's Certificates have been illustrated in connection with different phases of an audit. As the reader has probably surmised, the number of certificates to be signed by the client may become a nuisance, hence many auditors have a Unified Client's Certificate wherein are embodied all of the certificates required by the auditor in the proper conduct of the audit, and for his own personal protection.

The certificate shown herein is taken from one used by a prominent firm of auditors of national scope.

Slow moving and obsolete materials may, as a rule, be included in the inventory at NET selling price (of obsolete goods); i.e. selling price less selling and other definite expenses connected with the sale thereof.
Price, Williams, and Seabury,
Auditors and Accountants,

Gentlemen:

The undersigned are fully familiar with the quality of the merchandise inventory and its salability at ___ _ ______ ; are also familiar with the method of inventory taking which was employed at said date and are fully satisfied and do hereby certify that in their opinion the aggregate amount of $ ___ is a true and correct valuation covering Quantity, Quality and Prices; that the prices used represent the lower of cost or market values at the date of inventory taking; that no slow moving or obsolete materials were included and that said amount does not include any merchandise consigned to the Company which has not been paid for, or the liability therefor not provided or acknowledged on the Company's records. The undersigned further state that Messrs. Price, Williams and Seabury are fully justified in stating said amount in their Balance Sheet at [date] as being a good current asset to the best of their knowledge and belief.

Accounts Receivable aggregating $____ ___ are all valid current accounts due from trade debtors of this Company and represent bona-fide sales. No consignment accounts are included therein. An allowance of $____ ___ is deemed sufficient to cover any shrinkage in these accounts, due to cash discounts, bad accounts, etc.

We have made every effort to get in all invoices covering materials received or expense incurred prior to the close of business [date] and, to the best of our knowledge and belief, provision has been made on the books of account for all liabilities of the Company at [date] with the exception of invoices aggregating $____ ___ covering merchandise in transit, no part of which has been included in the inventory or charged to our trade at [date] ; except as herein below noted, the Company was not, at the date stated, liable as endorser or guarantor on any accommodation paper, contract or agreement whatsoever; had not pledged or assigned any of its assets; had no outstanding contracts of a speculative nature for material or other items; had no damage or lawsuits or judgments pending against it or was not otherwise contingently liable on account of discounted notes, trade acceptances or other form of obligation.

All cash funds including petty cash funds held by employees in the office, store or plant were submitted to a representative of Price, Williams, and Seabury, except as noted herein below.

There have been no special matters occurring during the period covered by this audit insofar as the officers of our Company have knowledge, which would have any bearing on your report and there have been no shortages or irregularities which have already been closed or which are now in abeyance. There are no suspicions or matters of a personal nature reflecting on the honesty of the members of our organization insofar as we have any information.

Very truly yours,
necessity of having to move to smaller or to larger or to more advantageous or to cheaper quarters; etc.

In an audit for a prospective purchaser, a full description of a lease must always be given, or if too involved, prominent attention must be drawn to its existence.

592. Taxes.—On a first audit, the auditor should ascertain to what year, if any, the client’s tax returns have been examined by a field inspector of the Internal Revenue Department. If they have not been examined for the last six years, the auditor should review them and if in his opinion the returns appear to be correctly prepared, he may properly omit mention of them in his certificate. On the other hand, if the returns are at all concerned, with most points, the auditor should protect himself, as well as the public, by qualifying his certificate in this respect. If the returns are found to be improperly prepared, the auditor must qualify his certificate if he is not employed to ascertain the correct tax and prepare the amended returns.

If the returns have been examined by a federal field agent, the auditor must ascertain the results thereof, and review the returns prepared since then. No rule of thumb can be given for the guidance of the reader as to how the auditor must set forth the facts, be they claims for an additional assessment by the government, or for a rebate by the client. Professional procedure cannot be so minutely described in spheres which distinctly call for expert judgment. The same comments apply in instances where the auditor’s cursory examination of the prior unaudited returns indicates substantial errors either in favor of, or against the client.

For a further discussion of this topic, read sections 450, 481, and 530.

In like manner a review should be made of all other kinds of tax returns.

593. Purchase Commitments.—It is sometimes stated that purchase commitments for future delivery (if made at a fixed price) may be disregarded, unless at the date of the balance sheet the market value is lower than cost, in which case a reserve should be set up. This point of view is often a very erroneous one to take. Consider the position of a concern which already has on hand too large an inventory. Is it not clear that the outstanding commitment, assuming no offsetting firm sales contracts, gives rise to a real current liability on the one hand and an asset of doubtful salability or currency on the other hand? In such an instance it is no fantasy to state that the mere mention of the commitment might result in the client’s banker refusing to continue its present line of credit. Since this is so, how much more important than ever it is to cover this important aspect of an audit when market prices are FALLING!

For further comments read section 267.

594. Construction Work.—Although it is not yet the universal current practice of auditors to mention in a balance sheet footnote the amount of liability under contracts in force for future additions to plant, nevertheless, leading auditors have clearly recognized the importance of it by doing

1Obviously, there are many instances where, even though the client does not expect to move, an unfavorable lease must be specifically mentioned in full detail. 2Even if the price has not been fixed, the amount (volume) of commitments is usually very important. 3See Appendix C, Sec. 12—#2. 4Even if no contracts exist, as when the client itself is undertaking the new construction, this information is usually vital.
so. Here is an instance where in the near future there will be a conversion of current assets into plant assets, or, if the contract is cancelled, there arises a liability for which no worthwhile consideration has been received. In either case the situation may have important meaning to a banker, creditor, or other interested party. Even if the expenditure is to be largely taken care of by a mortgage or a bond issue and therefore will not jeopardize the current working capital, nevertheless, it may cause a banker, for example, either to contract or cancel the client's present line of credit on the basis that an expansion at the present time represents, in his opinion, a decidedly mistaken program. Although this illustration is supposititious, it is believed that it is not far-fetched, the point being that it is not for the auditor to decide whether or not this information is or is not of importance to some one. His clear duty is to make note of it on the balance sheet.

595. Stock Not Fully Paid up to Par.—Stock not fully paid up to par is divisible into at least two classes. First, when stock is legally subscribed to at less than par, the stock becomes fully paid and nonassessable, so far as the corporation is concerned, when the subscription price has been paid. That is to say that there is an implied or written contract between the stockholder and the corporation that no further sum is due on the stock than what has already been paid in (i.e., the subscription price), even though it is less than par. However, the stockholder still has a contingent liability to the corporation that no further sum is due on the stock than what has already been paid in (i.e., the subscription price), even though it is less than par.

In brief, the corporation can give up its own right to the discount, but it cannot void the rights of creditors. From this explanation, it may be seen that no notice of the contingent liability needs to be taken as long as the business is in good financial shape. When such is not the case, the auditor will have to make whatever provisions the seriousness of the particular situation calls for.

Second, when stock is subscribed to at par, but is issued to the stockholder before being fully paid for, BOTH the corporation and the creditors have a right to call on the stockholder for the amount of his unpaid balance. In this type of case there are three distinct situations for the auditor to consider: (1) The discount may be admitted by every one to be a real current liability. That is, the stockholders fully expect to be called upon from time to time in the near future for installments on the unpaid balance. If this is so, the balance sheet should show the unpaid balance as a current liability. (2) If there is only some likelihood of the unpaid balance being called for; i.e., if the call is not expected, and yet would not occasion surprise if notice of it did come, the unpaid balance could be set up on the balance sheet as a deduction from the gross asset rather than as a current liability. (3) If the contingency of a call is so remote that it would occasion genuine surprise to the stockholders, there is no serious objection to omitting all reference to it, provided also that the auditor is satisfied from his inquiry as to the solvency of the corporation that the call will not be made.

In both above cases the stock becomes fully paid up in respect to the corporation and the creditors to the amount of the unpaid balance (or discount) which is written off to surplus by proper vote of the board of directors. In due time, therefore, the contingency may entirely disappear in

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1See Appendix C, Sec. 6-#4. 2I.e. Stock held as an asset, NOT the client's capital stock. 3Whose stock is held. 4The debit would be to the asset (stock) account. 5That is, par value. 6Or, the facts could be stated in a footnote.
this matter as dividends are declared but withheld as a cancellation of the discount.

When additional liability beyond par value attaches to a stock, such as the common double liability feature of bank stocks, the auditor need take no notice thereof, provided the corporation (whose stock is held) is in sound condition. If this is not true, the auditor will have to make whatever provision in his opinion the particular circumstances call for.

596. Accumulated Dividends on Preferred Stock.--Naturally, accumulated dividends apply only to Cumulative preferred stocks. Even if adequate surplus exists, there is no dividend liability unless and until the directors vote it. Indeed this discretionary power of the board of directors is so well recognized at law that a stockholder must have an exceptionally strong case showing gross abuse of power by the directors to get a court to even entertain the suit, let alone to render a favorable verdict.

Dividends in arrears are commonly stated in a footnote which gives the last date on which a dividend was paid and the amount accumulated to date. If sufficient surplus exists, this is sometimes (rarely) separated to show the amount applicable to the preferred stock.

597. Insurance Taken Out in Mutual Companies.--As a rule, fire and other insurance policies of mutual companies contain a provision providing for a possible additional assessment if the company should become financially embarrassed. For example, The Standard Workmen's Compensation and Employees' Liability Policy of a certain insurance company of Boston has the following notation: "The total amount of the contingent mutual liability of the Insured under this policy is 100% of the premium contracted to be paid." However, the contingency is so remote in these cases that no mention of it is usually made.

598. Surety Bond.--Since experience shows that the liability of a bondsman often becomes real, a balance sheet notation of the facts should be given.

599. Contract Files.--The contract files of the client, or the equivalent whatever it may be in a particular case, must be examined by the senior auditor, and abstracts of the contracts should be made for the permanent file of working papers. Everything which might have some future significance should be noted, as it is always better to have some dead material than to be short on essentials.

600. Unused Letters of Credit.--A business which has unused letters of credit in the hands of agents has a contingent liability when it is considered that at an audit date the agents may have drawn drafts under the letters of credit, notice of which has not yet reached the client. As the drafts will have been drawn against goods purchased, the contingent liability is of that type which is accompanied by an asset. Nevertheless, it is not permissible to cancel the asset against the liability by omitting all reference to the facts.

601. Sale of Property Subject to a Mortgage.--If the client has sold property property on which he has already given a mortgage, there is a contingent liability involved therein, provided the buyer did not assume the mortgage. Thus, if the property is foreclosed by the mortgagee at a price less than the mortgage, the client is responsible to him for the unpaid balance.

1See Appendix C, Sec. 14-#12. 2If the facts as at the audit date become available to the auditor before he leaves the engagement, he must
If the property is in good shape and if there is no information that the mortgage is going to be foreclosed, the contingency is so remote that no mention of it is usually made. However, the client should always keep in touch with the situation until such time as he is fully relieved of his obligation to the mortgagee.

602. Uncompleted Firm Sales Contracts.—Undoubtedly it will not occur to a novice that uncompleted firm sales contracts are sometimes a prolific source of contingent or real losses. For example, if the cost of materials and/or labor have risen sharply, there is considerable probability that the unfinished firm sales orders will cost more than the already fixed contract price. Of course, if the client has wisely covered himself in so far as possible by material purchase commitments and/or labor agreements at prices upon which the firm sales orders were quoted, no loss is apt to result.

603. Retirement Provisions in Preferred Stocks.—If the provisions of a preferred stock provide for its retirement soon after the balance sheet date, the auditor should mention the fact, even though these stockholders may not be legally able to sue for specific performance. Although many auditors may not agree that this balance sheet notation is required, nevertheless, in the writer's opinion, it is such procedures as this which lift auditing out of the realm of subservience to rules and regulations into the sphere of dynamic usefulness to outsiders financially interested in the business.

604. Foreign Drafts.—Although some banks will take foreign drafts for collection only other banks will actually discount the drafts as soon as the goods are shipped. In the latter case, the exporter will probably have debited cash and discount, and credited the customer's account before he actually knows that the customer has "accepted" the draft. Since some foreign shipments are very much subject to cancellation and rejection, it seems advisable to regard the proceeds of these particular drafts as a liability until such time as it is definitely known that the drafts have been "accepted". Usually a footnote stating the amount of contingent liability on unaccepted foreign drafts so sold is sufficient.

In his verification of this contingent liability, the auditor should get an independent confirmation of it from the discounting bank. Moreover, the auditor should ascertain and report on the amount of unpaid drafts, as at the audit date, which has been settled before he finished the engagement.

605. Minutes.—Attention will now be called to the minutes of the board of directors, of the stockholders, and of special committees. These corporate records often yield by far the most important information imaginable. Indeed, if the auditor is refused access to a minute book, he must qualify his certificate in this important respect (Plate 149b).

In abstracting the minutes, items which do not concern the auditor, such as for example the fact that the meeting was held in the Main Office on Pritchard Ave. etc., should be passed over. Moreover, it is not always essential that even important items be copied verbatim, but when in doubt about it, the auditor will find that it will pay him to take the time necessary to make an exact copy.

The following items are typical of those which the auditor will abstract.

1. Election of the officers.
2. Amount of salary to be received by each executive.

(Cont.) show them as REALITIES, not as contingencies. And, of course, the auditor too. If such unaccepted drafts are treated as assets, by credits to sales, etc., the auditor must state the amount in a footnote.
3. Authorizations of the purchase of property for stock.
4. Authorizations of the valuation of such property.
5. Authorizations of bond and stock issues.
6. Declarations of dividends.
7. Appropriations of surplus.
8. Authorizations of major additions and betterments.
9. Authorizations of contracts for the acquisition of other corporations or interests therein.
10. Authorizations of special bonuses.
11. Authorizations to settle suits in litigation.
12. Authorizations of the sale of plant property.
13. Authorizations of the making of large purchase commitments.
14. Authorizations to start court action on infringement of patent or other rights.
15. Authorizations for the settling or contesting of additional tax assessments.
16. Authorizations for the increase and/or decrease in existing capital stock issues.
17. Appointments of depositaries, trustee, registrar, transfer agent, and so on.
18. Authorizations of contracts with factory superintendent, sales-manager, and others.
19. Authorizations of surety bonds.

606. Guarantees of Principal and/or Interest of Mortgages of Subsidiaries—Guarantees of principal and/or interest of mortgages of subsidiaries must be set forth in a clear-cut manner such as by a footnote.

606a. Audit Program.
(1) Keep constantly in mind that very often the contingent liabilities are the most important facts to be ascertained on the audit.
(2) Always be on the "qui vive" to uncover contingent liabilities, for usually they are not on the books of account. When reading contracts, deeds of trust, capital stock provisions, directors' minutes, etc., be on the alert for indications of contingent liabilities. Interviews with officers, directors, employees, etc., often lead to the unexpected discovery of such liabilities because of certain remarks inadvertently (or otherwise) dropped during the conversations.
(3) When confirming any matter by direct correspondence, remember to include (if feasible) an inquiry as to the possible existence of contingency liabilities.
(4) Secure a certificate on this point from the client. Get the client's attorney to sign it, too.
(5) Distinguish between contingent liabilities that give rise to assets and those which are not thus offset. Keep constantly in mind that assets which arise in this manner are usually of little or no value.
(6) If notes or accounts receivable have been discounted through an unusual channel (e.g., sale to a finance company), full disclosure is necessary on the balance sheet.
(7) The provision for bad debts must always be sufficient to absorb possible loss on accounts and notes under discount.
(8) In preparing footnotes keep in mind that "putting one on notice" is not equivalent of "giving one information." Banks, and other similar parties, can usually secure the additional information hinted at by the

1See Appendix C, Sec. 14-#14.
2In many instances the stockholders control these matters.
auditor as being necessary to an adequate understanding of the financial statements, but this is not often true of most stockholders or the general investing public.

(9) Advise the client not to make avoidable accommodation endorsements as the accommodated party is usually in poor condition. Ascertain if it is ultra vires for the business to give accommodation endorsements. See charter and by-laws.

(10) See section 556 for comments on guarantees of product and services.

(11) Examine and scrutinize the books of account for evidences of unrecorded bank acceptances. Include an inquiry thereon in correspondence with banks. Secure a written statement thereon from the client. Compare the order and receiving records with the purchase invoices. Check entries on creditors' monthly statements with entries in the corresponding trade-creditors' accounts. Examine bank charges carefully.

(12) Examine all leases. If any decidedly unfavorable leases exist, consider the necessity for making a full disclosure of them.

(13) On a first audit ascertain to what year a federal field agent has examined the income tax returns. Review his reports (if any) if the matter is still alive and pertinent. Review the tax returns prepared since then to date. Qualify the Auditor's Certificate to the extent deemed necessary.

If the last six years have not been passed upon, review these returns. If the returns are concerned with moot points, qualify the Auditor's Certificate. If the returns are found to be improperly prepared, the Auditor's Certificate must be qualified if the auditor is not employed to ascertain the correct tax.

Make the qualifications, if any, as definite in amount as possible. If the proposed additional tax has been stated by the federal government, give that figure and the amount, if any, which the client believes to be correct.

Review and pass upon all other kinds of tax returns.

(14) Review all sales contracts. Give definite facts on firm sales contracts undertaken at prices that must (or may) result in losses to the extent not covered by present inventories, purchase commitments, labor contracts, etc. Set up a liability reserve, if necessary.

(15) Review all purchase commitments, and state their dollar or volume amount. Give definite facts as to probable losses or gains on commitments not covered by firm sales contracts. Set up a liability reserve, if necessary.

(16) Give in a balance sheet footnote the amount of any expected unusual future additions to plant. State how these additions are to be financed.

(17) If a business, whose stock is held, is in poor shape, ascertain if the par value stock has been paid in, or the discount, if any, cancelled by dividends declared but withheld. If not, an additional assessment is likely. Show it as a current or contingent liability according to the likelihood of the assessment.

If the stock (subscribed to at par) was purchased at a discount, ascertain if the corporation expects to make a call for some or all of the unpaid balance. If so, show the amount as a current liability through a debit to the asset (stock) account.

(18) Dividends in arrears on cumulative preferred capital stock must be stated in a balance sheet footnote which gives the last date on which the dividend was paid and the amount accumulated to date.

If sufficient surplus exists, this may be separated to show the amount applicable to the preferred stock, if the client prefers this method to the footnote.

(19) Ascertain if any stock held is immediately subject to an assessment beyond the par value. If so, show the amount as a current liability. If the
assessment has been or will be contested at law, a footnote is usually sufficient.

(20) The contingent liability on mutual insurance company policies need not be stated unless the contingency has become quite likely.

(21) Review the contract files. Make abstracts for the permanent file of working papers.

(22) Show as a balance sheet footnote the amount of all unused letters of credit. If information becomes available before leaving the audit as to the actual amount of drafts drawn at the audit date, embody it in the accounts.

(23) Make a balance sheet footnote of any preferred stock issue that is retired soon after the audit date.

(24) Make a balance sheet footnote of any foreign drafts (accepted for collection only) that have been treated as assets and credited to sales prior to their actually being accepted by the customer.

(25) Review and scrutinize carefully the minutes of all boards and committees for possible clues to contingent liabilities, etc.

(26) Set forth in a clear-cut manner, as a balance sheet footnote, any guarantees of principal and/or interest of mortgages, etc., or of dividends etc., of subsidiaries, etc.

(27) In the case of a contract for a construction project subject to a time limit penalty for delay, do not report this contingent liability unless the penalty will probably exceed the unearned income on the project.

**ADDENDUM**

"LIABILITIES, CONTINGENT: (1) Liabilities arising only in the event of something which may or may not happen. They may be classified in several ways:

(a) Definite liabilities, which may be found by an examination of the accounts and records, such as liability on notes re-discounted, arrears of dividends on cumulative preferred stock, unpaid subscriptions on stock, endorsements or guarantees which have been given, payments on leases, etc.

(b) A second class is more difficult to trace, for it includes such items as guarantees in the sale of goods or services, contracts for future deliveries, cancellation of sales on time, returned merchandise, pending law suits or judgments under appeal.

In any event, a balance-sheet should show on its face, or in a footnote, any contingent liabilities which may exist and can be traced.

(2) Liabilities which may arise in the future as a result of transactions in the past and, if arising, will result, in some cases, in a corresponding contingent asset but not necessarily of equal value, e.g., notes receivable or acceptances discounted; accommodation and other endorsements; guarantees; warranties; suretyship; contractual liability to make good defects in work done or goods supplied; contractual liability for purchase and sale for future delivery (of paramount importance in a widely fluctuating market); additional tax assessments disputed and in process of review and reconsideration by tax authorities or being adjudicated in the courts; unsettled claims for personal injury or property damage; law suits and disputes of any nature, not included above, involving a possible actual liability if finally decided adversely. Unpaid calls on stock subscriptions should not be classified as "contingent liabilities" unless the call dates are uncertain and contingent upon the subsequent action of the issuing company. Additional assessments on stock holdings are of rare occurrence and are usually contingent upon the action of a reorganization committee or
Reserves or provisions are sometimes created to cover contingent liabilities when there is a probability, based upon past experience or upon the attendant facts, that at least a portion of the amount involved will eventually have to be paid without recovery from others, but, even in these cases, if the matter is adjudicated in the courts, the reserve or provision is sometimes omitted on the theory that the entry may be judicially interpreted as a tacit admission of liability—doubtful accounting policy but possibly good legal strategy."—By the Committee on Terminology of the A.I.A.

REVIEW QUESTIONS

1. Why is it necessary to review firm sales orders in a search for contingent liabilities?
2. A concern becomes the primary obligor on an accommodation endorsement. What entry should it make?
3. Subdivide Guarantees of Products and Services into three categories, and explain the treatment to be given to each.
4. Why is there generally considered to be no contingent liability in connection with bankers' acceptances under discount?
5. In what way might a lease involve an important contingent liability?
6. How does a contract let for new construction work give rise to a contingent liability?
7. In your opinion, is it necessary to mention the fact that a provision in the preferred stock calls for its retirement soon after the audit date?
8. In what sense is there a contingent liability under unused letters of credit?
9. Divide contingent liabilities into two categories. Give examples of each.
10. How can there be a contingent liability under a sale of property subject to a mortgage?
11. Give four ways in which the amount of notes receivable under discount may be shown on a balance sheet.
12. How can a client secure goods from a banker under a trust receipt?
13. Wherein may there be a contingent liability under foreign drafts?
14. What is your opinion of the following presentation?

FIRST MORTGAGE 6 1/2's SINKING FUND GOLD BONDS:
Matur- ing September 1, 1933 (sinking fund requirement
$1,000,000 July 15, 1932 and 1933) . . . . . . . . 2,000,000.00

CHAPTER 39

RESERVES

607. General Comments.
609. Reserves as Assets.
611. Secret Reserves.
613. Explanation of Plate 192.

PLATE 192 - A Schedule on Networth.

Review Questions.

607. General Comments.— It is well known that the title Reserves has caused and is causing endless confusion, and, in the hands of unscrupulous officers, the aggregate of the reserves (no details whatever being given) is often placed in the balance sheet in such a location that the unsophisticated are led into believing that all of it is a part of surplus. In other instances, the Reserves are so classified in the balance sheet (but listed in some detail) in continuance of a long established policy of showing them in that manner and location, or in compliance with the rules and regulations of a public utility commission.

ILLUSTRATIONS

General Motors Corporation
Condensed Consolidated Balance Sheet
As of December 31, 1927 and 1926

Liabilities, Reserves and Capital

<table>
<thead>
<tr>
<th>Current Liabilities: (details not given here)</th>
<th>Dec. 31, 1927</th>
<th>Dec. 31, 1926</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Current Liabilities</td>
<td>$159,356,147.36</td>
<td>$144,322,596.00</td>
</tr>
<tr>
<td>Reserves:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation of real estate, plants and equipment</td>
<td>$141,872,939.54</td>
<td>$123,892,342.01</td>
</tr>
<tr>
<td>Employees' investment fund</td>
<td>6,316,320.00</td>
<td>2,956,795.50</td>
</tr>
<tr>
<td>Employees' savings funds#</td>
<td>14,933,833.65</td>
<td>8,520,447.42</td>
</tr>
<tr>
<td>Bonus to Employees</td>
<td>11,715,710.51</td>
<td>6,520,447.42</td>
</tr>
<tr>
<td>Sundry contingencies</td>
<td>3,943,565.78</td>
<td>4,613,921.20</td>
</tr>
<tr>
<td>Total Reserves</td>
<td>$176,762,369.48</td>
<td>$139,883,506.21</td>
</tr>
<tr>
<td>Capital Stock: (details not given here)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Capital Stock and Surplus</td>
<td>$760,339,058.74</td>
<td>$636,678,008.68</td>
</tr>
<tr>
<td>Total Liabilities, Reserves and Capital</td>
<td>$1,098,477,575.58</td>
<td>$920,894,514.89</td>
</tr>
</tbody>
</table>

#Reserve for employees' savings fund includes classes maturing December 31, 1929 to December 31, 1932 after providing an amount in "Taxes, payrolls and sundry accrued items not due" to meet probable withdrawals during 1928. Classes maturing December 31, 1927 and 1928 are also included in "Taxes, payrolls and sundry accrued items not due." At December 31, 1926 all classes of the employees' savings fund were included in "Taxes, payrolls and sundry accrued items not due."

1Note - These excerpt illustrations have been condensed by the writer at points not applicable to this discussion.
Bell System Balance Sheet, December 31, 1927
(Inter Company Duplications Excluded)

Liabilities

- Capital Stock $1,351,939,840
- Funded Debt 919,789,700
- Bills Payable 7,046,158
- Accounts Payable 63,597,120
- Accrued Liabilities 91,115,456
- Employee's Benefit Funds
  - Provisions for accident and sickness disability benefits, pensions and death benefits
- Surplus and Reserves:
  - Combined surplus and reserves of Bell System companies invested in the telephone business. Increase during year $148,892,896.
  - The item Surplus and Reserves is comprised of:
    - Reserves for Depreciation of Plant and Equipment $600,663,640
    - Reserves for Contingencies 91,258,481
    - Surplus (including Capital Stock Premiums) 296,953,269
- Total Liabilities $3,457,457,311

The B.F. Goodrich Company
(A New York Corporation)
And Subsidiary Companies

Consolidated Balance Sheet
December 31, 1926

Liabilities

- Current Liabilities $6,624,651.22
- 5% Serial Gold Notes 15,000,000.00
- 25 Year 6 1/2 1st Mtg. Gold Bonds, Due July 1, 1947 23,044,500.00
- Reserves:
  - From Surplus - for Contingencies in connection with
    - Affiliated Company acquired $1,700,000.00
    - For Pensions 600,000.00
    - Miscellaneous (Including Rentals Received in Advance Applicable to Future Years) 251,555.62
- Capital Stock and Surplus 60,074,897.85
- $107,295,604.69

(It is believed that these three illustrations are sufficient to show (1) the incongruous nature of the items placed under the caption of Reserves and (2) that no attempt is made to arrive at a figure for the total liabilities and one for the total networth).

#Author's note—Details omitted by him.

608. Classification: An analysis of the problem shows that reserves can be divided into five types: (1) those which are true liabilities (2) those which are offsets (3) those which are segregations of earned, or

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1See the end of this chapter.
paid-in capital surplus, (4) those which represent unrealized profits, and (5) those which are of a genuine contingent nature.

By consensus of opinion, it is agreed among those who are interested in clear-cut accounting terminology that the term reserve, if used at all, should be applied only to certain items in class 3, and to class 5. As to class 1, the caption, "provision" or 'accrued' should be used in addition to the word 'payable'; thus, "Provision for Federal Taxes Payable" or "Accrued Federal Taxes Payable". For unrealized surplus, class 4, the description might run, "Capital Surplus from..." Thus, if it is in connection with donated treasury stock, the caption would read, "Capital Surplus from Donated Treasury Stock", or, if arising from an appraisal of plant properties, it would be, "Capital Surplus from Appraisal of Plant". Finally, the word 'allowance' has been widely accepted among theorists as a suitable caption for accounts falling in class 2. And happily a review of published balance sheets shows that the description has been adopted by a few of our 'best corporations'. It is earnestly hoped, however, that the business world in general will see fit to adopt the new terminology more rapidly. Meanwhile all proponents of the term should use it on every possible occasion.

609. Reserves as Assets.-- The term reserve is also commonly used both by the general public and by bankers in a sixth sense to mean a sum of money or investments. When applied to banks, the word reserve undoubtedly does have an unmistakable significance and meaning, built up as it has been by long usage and by the statutory wording of the various bank acts. It would seem, therefore, to be unwise to attempt to dislodge this special meaning from bank accounting terminology, but for commercial enterprises the word fund should be used in these instances.

610. Covered Reserves.-- A reserve is said to be a covered reserve when specified funds of like amount have been created for the purpose for which the reserve exists. A well known example of it is the combination of the bond sinking fund and the bond sinking fund reserve commonly required by mortgage indentures. Reserves for Pensions, and Reserves for Fire Losses are also likely to be covered, at least in part.

1On the other hand note the following: "The word 'allowance' is occasionally used synonymously with the word 'reserve', e.g., allowance for depreciation or allowance for bad debts, but this usage should be avoided." "The expression 'reserve for depreciation' is so generally used and understood by bankers, the business world and accountants that its use should be continued." -- —By The Committee on Accounting Terminology of the A.I.A. In the writer's opinion this sanction is regrettable.

2Appropriated Earned Surplus:
Reserve for Bond Sinking Fund $xx
Reserve for Extension of Plant xx

3The following portion of a bank statement will illustrate more fully the meaning of the term reserve in bank terminology.

RESOURCES
Gold with Federal Reserve agents $xx
Gold redemption fund with U.S. Treasurer xx
Gold held exclusively against F.R. notes $xx
Gold settlement fund with F.R. Board xx
Gold and gold certificates $xx
Total gold reserves $xxx
Reserves other than gold $xx
Total reserves $xxx
611. Secret Reserves\(^1\)--Of course, secret reserves are not reserves at all, i.e. they are not ledger accounts. The term has sprung up to describe a business whose networth is intentionally or accidentally understated by reason of an under valuation of assets or an overstatement of liabilities, or both.

As to assets, these are commonly undervalued by taking too much depreciation; by charging additions and renewals to repairs; by not recording the increase in value of an asset due to the rise in price levels; by valuing inventories below cost or market or below other sound and recognized bases; by omitting prepaid expenses; by charging extraordinary repairs to cost of operations; by overestimating the amount of depletion; by setting up excessive allowances for doubtful notes and accounts; by crediting asset accounts with the income earned by these assets; by omitting assets altogether; by not recording the rise in value of an asset due to the increase in its growth; and by diverse other methods.

On the other hand, liabilities are not so easily erroneously or purposely increased, because, as has been emphasized, the element of judgment in their valuation is not so prevalent as for assets. In most instances, but there are important exceptions, there is some original source which will show that the liability is down to the last penny. Of course, as was also pointed out previously, the item of federal income tax payable has been subject to large errors, especially during the period when rates were based on invested capital. Likewise, provisions for definitely known losses such as on legal suits under contest, which are admittedly lost but whose damage costs are unknown, may be overstated. (This is, of course, merely a possibility, not a probability.) Finally, when the element of intentional manipulation enters, the liability and contingent RESERVES are usually the type of liability accounts which are credited with too liberal an estimate.

In regard to the justification of secret reserves, the undoubted weight of opinion is that the ability to absorb extraordinary losses without any disastrous results is just as good with an openly stated surplus as with an understated net worth, for, after all, these are merely bookkeeping entries. Thus, in the first case the losses are charged to surplus, whereas in the latter instance they are charged to an understated asset account or to an overstated liability account, or in part to both, the effect of which is to fully or partially correct the valuation of the asset or liability, as the case may be.

In some quarters the position is taken that the directors know best what information should be disclosed even to the stockholders, i.e. to the very owners themselves. To a neutral observer this contention does not seem valid. In the hands of an unscrupulous directorate, secret reserves are too convenient a smoke screen by which to cover up questionable and fraudulent operations. Furthermore, even if this fear of manipulation is admittedly given too much weight, there are many additional reasons of considerable merit, among which are the rights of present stockholders, and of prospective investors and creditors, to know the actual condition of the company, but especially the former class. Financial history is entirely too replete with instances where misinformed stockholders have sold their small holdings at a loss, even on the very eve of a "melon cutting".

These following opinions give the auditor more latitude than the writer thinks is advisable.

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\(^1\)See Appendix C, Sec. 13-#1; Sec. 15-#11, Sec. 26.

\(^2\)I.E. increased (purposely) in such a way as to easily escape detection by the auditor.
"If the Balance Sheet be so worded as to show that there is an undis­closed asset, the existence of which makes the financial position better than shown, such a Balance Sheet will not, in my judgment, be necessarily inconsistent with the Act ... . The purpose of the Balance Sheet is primarily to show that the financial position of the Company is at least as good as there stated, not to show that it is not or may not be better. There are legitimate reasons for ensuring secrecy to a proper extent ... . It is not, I think necessary nor ... desirable to expose persons who trade under these (the Company) Acts to the necessity of a publicity from which their competitors are free, unless such publicity is required to ensure commercial integrity.

"It would appear, then, that the auditor may report, in his discretion, having regard to all the facts of the case, with or without disclosing the secret reserve, provided the reserve is being legitimately employed in the interests of the Company, and is not being used so as to benefit certain parties, e.g., directors, to the detriment of others. Any clause in the Articles seeking to prevent the Auditor so reporting, is ultra vires and void"— Newton v. The Birmingham Small Arms Company Ltd. (1906)

"Adopting a prudent financial policy, particularly as to basis of valuation, the Balance Sheet may disclose a weaker position than is actually the case, but the accounts must not be misleading. . . . . . . . . . If the Auditor is of opinion that: An undisclosed asset is one, the existence of which makes the position of the company WORSE than that shown; or the rights of third parties intervene (a manager to a percentage of profits); or the directors are manipulating the Balance Sheet for purposes of their own, he should refer to the omissions in his report"— Taylor & Perry.

612. Liabilities and Networth.—It is sometimes stated that it is characteristic of trivial minds to prefer a different title than LIABILITIES for the caption of the right hand side of a balance-sheet drawn up in account form. In the writer’s opinion, this criticism is invalid for it is well recognized on every hand that a sharp distinction should be made between the liability and the networth sections of a balance sheet. The first step in this direction, therefore, should be to recognize the difference by a more carefully worded caption, such as Liabilities and Capital, or Liabilities and Networth. Furthermore, as emphasized in section 822, any form which follows the order of capital stock, liabilities, surplus and reserves should be abandoned, for it is quite impossible under this arrangement to present a single figure for the grand total of the capital, and one for the liabilities.

613. See Plate 192.

613a. Audit Program.
(1) Use the term "Reserve" as little as possible. For example, change "Reserve for Extension of Plant" into "Earned Surplus Appropriated for Extension of Plant".
(2) Classify all reserves into:
  (a) liabilities (b) offsets to assets (c) segregations of surplus
  (d) unrealized profits (e) true contingency appropriations of surplus.
(3) Use the term fund (not reserve) when referring to assets.
(4) If secret reserves are countenanced, be prepared to defend your action. Remember that the objectives said to be obtainable only by the creation of secret reserves are "after all is said and done" matters of financial policy. Full disclosure of the true financial condition does not preclude the obtaining of reasonable objectives. Keep constantly in mind
CAPITAL

CAPITAL STOCK:
Seven Percent Preferred - Non Cumulative:
Authorized 10,000 shares, Par $50 - Issued 8,000 shares $400,000.00
Common:
Authorized and Issued 25,000 shares, Par $100 2,500,000.00 $2,900,000.00

SURPLUS:
Capital:
Appraisal Surplus - Plant $231,869.42
Donated Capital - Plant Site 175,000.00
Profit on Sales of Securities 50,000.00
Profit on Sales of Plant Assets 50,000.00 $506,869.42
Earned:
Appropriated:
Reserve for Sinking Fund $180,000.00
Reserve for Plant Extensions 145,000.00
Reserve for Contingencies 220,000.00
Total $545,000.00
Unappropriated:
Balance January 1 $285,133.25
Net Income (Exhibit B) 683,498.62
Total (a) $968,631.87
Less - Appropriation to Sk Fund $20,000.00
Dividend - Preferred Stock 28,000.00
Dividend - Common Stock 200,000.00
Total (b) $240,000.00
Net (a - b) 1,728,631.87 1,772,501.29
TOTAL CAPITAL $4,672,501.29

613. Explanation and Comments.—This plate shows the nature of the items properly included under capital. Special attention is directed to the two-fold classification of Surplus into "Capital", and "Earned", of which latter there are two kinds, namely, "Appropriated" and "Unappropriated." Notice also that the capital stock is summarized in one figure and the surpluses in one figure, the sum of the two being the total capital.

The "Reserve for Contingencies" was set aside without there being any contingency in mind.
that the stockholders are the real owners of the business, and hence entitled to complete information.
(5) Unless the client objects to it, etc., use the title, "Liabilities and Networth", or "Liabilities, Reserves; and Capital" in place of "Liabilities" as the caption for the equity side of the balance sheet.
(6) As a rule classify as a liability any reserve that has been established by a charge to current operations. Thus allowances for repairs and maintenance, self insurance, etc. are liabilities.
(7) Classify as surplus any contingency reserve that has been established by a charge to surplus as a means of reducing the amount of unappropriated surplus available for dividends.
(8) Always show in some manner the changes that have taken place in the reserve accounts stated in §2c-e inclusive above.
(9) Examine all authorizations by the board of directors, bond or stock provisions, etc.
(10) Do not permit operating expenses to be charged against reserves set up out of surplus.

APPENDIX

"RESERVE: The correct use of this word, as applied to an account, will be facilitated by reference to its derivation--re:back, and servare: to keep, i.e., a keeping back or withholding.
A reserve account indicates segregation and withholding, for a specific purpose, of past or current profits, revenue or income from any source. It is invariably a credit account and may be provided to cover:
1. An estimated loss in value of physical property which has occurred theoretically in the past or arises from past operations or activities; e.g., reserve for reserve for wear and tear.
2. An estimated or actual loss in value of choses in action, e.g., reserve for bad and doubtful debts, reserve for depreciation or fluctuation of securities (to cover repudiation, bankruptcy, insolvency or merely a temporary fluctuation).
3. A discounting or proration of future estimated or actual loss of exclusive use or possession of intangible capital such as patents, copyrights, franchises, leaseholds, rights of way, water rights or special terminable privileges or rights of any kind which have been capitalized. A reserve for amortization should be used in this case where lapse of time is the governing factor.
4. An estimated loss in value of physical property which may (problematical as to occurrence) or will (problematical as to extent) occur in the future, e.g., a self-insurance reserve to cover loss by accident, casualty or action of the elements.
5. An estimated future expenditure for compensation to employees or others, e.g., reserve for workmen's compensation or reserve for accident liability.
6. An estimated future expenditure or loss on account of guaranties or endorsements, contingent upon the future action or non-action of other parties to the transactions, e.g., a reserve for notes discounted or a reserve for accommodation endorsements; or an estimated future expenditure or loss contingent upon breach of warranty or upon non-fulfilment of contractual conditions, e.g., reserve for tire mileage.
7. An estimated future expenditure for capital outlay, the reserve being created to conserve the available cash balance by reducing the amount of unappropriated surplus, e.g., reserve for capital additions. This is an improper use of the word "reserve." "Appropriated surplus" is better.
8. An actual or estimated loss in value of tangible property of any kind.

1I.E. true contingency reserves.
which has occurred in the past, probably not wholly recoverable by insurance and in process of amicable adjustment with, or disputed by, insurers; e.g., reserve for fire loss. A loss of possession of tangible property of any kind due to burglary, larceny, embezzlement or defalcation, not covered by insurance, should, upon discovery, be written off to an appropriate nominal account. A reserve should not be created for such a loss. The property value should be re-instated in the assets and the nominal account should be credited, if and when recovery ensues. If, however, the exact amount of the loss may not be determined for some time, an appropriate reserve account may be set up in the books as a temporary expedient, subject to clearance and adjustment when the facts are known.

A reserve to cover losses occurring either in the past or future, if it is provided with knowledge that loss has occurred or will occur and that such loss is a direct consequence of past operations, is an abatement of the corresponding assets, not a segregation of surplus.

Reserves which are set up to cover losses or contingencies that are expected to arise in future operations are segregations of surplus. Reserves set up to pay for additional assets are in the same category.

Some eminent accountants have used the word reserve to describe a "reserve fund," but this practice, which is an excellent example of the confusion existing in accounting terminology, is falling into disuse. (See "fund.")

Reserve is also used to denote something stored up for future use or in excess of current needs, e.g., a reserve stock of materials, or to denote something set apart for a particular purpose, e.g., a reserve of land, but in neither case is it customary to carry that designation into the books of account.

The word "reserve" is used to denote the minimum ratio of cash and choses in action to the amount due depositors which banks are required by law to maintain at all times.

Note: A reserve for loss on containers or on other property delivered to vendees and to be returned by them has fallen into disuse in most industries as such a loss is now usually obviated by a tentative charge or actual deposit.

Briefly, in accounting a reserve is (1) an amount out of what otherwise would be the net worth (generally by charges currently made to operating accounts and in other cases by specific provision made at the close of an accounting period), intended to provide for liabilities believed to exist but not otherwise taken into account and for any difference between book and actual value of assets—such reserves are part of the liabilities or are applied to the value of assets; or (2) an amount reserved out of surplus for some specific purpose, such as expansion of business, retirement of preferred stock, etc. Reserves of the latter class are no more than parts of the surplus separated for some special use and are not liabilities."

—By the Committee on Terminology of the A.I.A.
REVIEW QUESTIONS

1. What sound objection is there to the following order of balance sheet presentation; Capital Stock, Liabilities, and Surplus?
2. What is the nature of each of the accounts included under Reserves in the balance sheet of the General Motors Corporation? Under "Surplus and Reserves" by the Bell System?
3. What is a covered reserve?
4. What is a secret reserve? How can they be created?
5. Make a classification of reserves.
6. Give reasons for and against secret reserves.
7. Is a self insurance fund reserve (credit) a valuation reserve (asset offset) or a liability reserve? Give reasons for your answer.
8. What is your opinion of the following decision?

"The special resolutions (i.e. the articles of incorporation authorized the directors to establish a secret reserve to be created and applied at their will without disclosure to the stockholders) in the present case provide that the balance sheet shall not disclose the internal reserve fund; it must, therefore, omit on the asset side of the balance sheet the assets which make up the amount standing to the credit of that fund and the contra item—namely, the credit balance of the fund—on the liability side. The result will be to show the financial position of the company to be not as good as in fact it is. If the balance sheet be so worded as to show that there is an undisclosed asset, the existence of which makes the financial position better than shown, such a balance sheet will not, in my judgment, be necessarily inconsistent with the Act of Parliament. Assets are often by reason of prudence estimated, and stated to be estimated, at less than their real value. The purpose of the balance sheet is primarily to show that the financial position of the company is at least as good as there stated, not to show that it is not, or may not be better."—Justice Buckley in the Birmingham Small Arms Company.
CHAPTER 40

THE VERIFICATION OF DEPRECIATION AND DEPRECIATION ALLOWANCES

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Review Questions.

614. Introductory Remarks.--The importance of depreciation in the
field of auditing is such that no apology is offered for presenting herein a
cursory view of many aspects of the subject which some may consider to be
material more properly included in a text on accounting principles. Indeed,
in the writer's opinion, a thorough knowledge of the theory of depreciation,
if seasoned with considerable contact with the practical application of it to
actual problems, is what constitutes a major share of the auditor's profes-
sional equipment at this particular point in the audit program, rather than
the possession of special skill in what might be called "the technique of
the verification procedure".
615. Going Concern Valuation.--As has been emphasized repeatedly throughout this text, the auditor's point-of-view must always be based on the fact that the client is a GOING CONCERN, unless, of course, special circumstances, conditions, or facts negative this assumption. Therefore, in the case of the ordinary commercial enterprise, scrap, junk or salvage value, sales price value, service value, earning value, taxable value, liquidation value, etc. have no place whatever in the depreciation program of the depreciable fixed assets. Just what depreciation course should be pursued in general, or in a particular case, and what facts are to be taken into consideration in determining it, constitute the theme of the following discussion.

616. Definitions.--At the very outset, two well-known definitions of depreciation will be given in an introductory attempt to clarify the nature of depreciation. "Depreciation attempts to measure the effect of time and production on physical properties and equipment and to record the result in dollars and cents." 1 "Depreciation, which is a financial result, has been confused with obsolescence, which is an economic process, and with deterioration, which is a physical condition. Either of the latter bring about depreciation, and the physical process rarely happens to be more rapid than the economic." 2

617. Depreciation is NOT a Reservation of Profits.--One of the major fallacies often entertained by the general investing public, and indeed by many others who are usually thought of as being well informed in the field of finance, is that the Allowance (Reserve) for Depreciation account is a reservation of profits. This situation has undoubtedly been largely induced by the erroneous presentations current in practically every prospectus. Thus a company (with annual depreciation of $50,000, profits of $70,000 before deducting depreciation, and capital stock of $150,000) will state in bold type that it has a net profit of $70,000 available for depreciation and dividends, whereas in truth net profits can never be ascertained without first deducting proper depreciation charges. The announcement is just as sensible as if it read that the $70,000 profit was available for the payment of materials consumed and dividends. Of course, the company has not concealed any facts necessary for one to determine the true profit, but it has purposely presented the matter in such a way as to induce the uninformed to reach the conclusion that the company earns 46%, whereas it earns only 13%. Furthermore, it is more than likely that, in the balance sheet accompanying the prospectus, this company will show the Reserve for Depreciation among the Reserves -- some of which, perhaps, will be liabilities and some surplus.

618. Actual vs. Theoretical Depreciation.--Actual (sometimes known as absolute) depreciation must be carefully distinguished from theoretical depreciation. Actual depreciation is the term used to denote the decrease in the sales value of an asset or the decrease in its serviceability.

Obviously, therefore, absolute depreciation (resale value) is not applicable to a going concern. Once a production asset has been installed, its resale value drops off tremendously. Thus in the case of a new water system project which was abandoned shortly after getting it started, a brand new concrete dam represented nothing more valuable than a testimony to the ill fated enterprise. Again, the automobile furnishes us with an excellent illustration of the way in which resale value drops off, in utter disregard to the use a thing has had. All of us know that the resale value of an auto-

1 "Depreciation"--U.S. Chamber of Commerce. 2 "Power for Profit"--R.P.Bolton.
mobile after being on the road only a single month is strikingly disproportionate to its remaining usable value. Likewise, actual depreciation from the standpoint of serviceability is not a sound basis on which to build a depreciation program for a going concern. Many, perhaps most, depreciable assets render from 100% to 75% service up to the very day on which they become totally useless. Thus a telephone pole, whose function is to hold up the wires, will do its job perfectly until the time it is retired or falls down.

Theoretical depreciation (sometimes known as accounting depreciation) on the other hand, is based on the assumption that the asset will be continued in service until its usefulness has ceased. Hence the aim of theoretical depreciation is to spread the net cost of the asset equitably over the total number of units produced by it during that time.

619. Depreciation Allowance is NOT a Sum of Money.—It may seem to some that it is a waste of time to emphasize that the depreciation allowance is not a sum of money. While it is true that this mistaken idea is not nearly so prevalent as it used to be, nevertheless, it is common enough to warrant pointing out that the Allowance account is merely a section of the credit side of the asset account to which it relates. It is, therefore, an asset VALUATION account; i.e., an account which must be subtracted from an asset in order to show the latter at its proper going concern value.

620. Depreciation vs. Plant Efficiency.—Sometimes the mistake is made of looking upon the ratio of the depreciation allowance of an asset to its cost as a measure of its efficiency. This is an altogether false assumption. Only in rare instances will the two be identical or even approximately so. As was pointed out in section 618, the efficiency of an asset generally ranges from 100% to 75% throughout its whole life, whereas the depreciation allowance must of necessity gradually and steadily approach and finally reach 100% of the net cost of the asset by the time it is retired. If these facts are kept in mind, the auditor should have no difficulty in answering the common complaint of clients that the depreciation charges at the rates now in force are altogether too large, as shown by the amount of this or that depreciation allowance as compared with the physical condition and efficiency of the asset to which it applies.

621. Depreciation on Present Replacement Cost.¹—The question as to whether or not the depreciation charge should be based on the original cost of the asset, or on the cost of replacing it in kind, etc., is still unsettled. There are leading authorities who maintain that the depreciation charge is not a provision for replacement. In their opinion depreciation is concerned solely with the equitable charging off of the net cost of the existing plant properties. To them the problem of having to acquire replacements in the future at a different cost is wholly or largely a matter of financing.

While this point of view has considerable merit to it, the weight of opinion undoubtedly is (1) that there are many occasions when the present

¹ Comment by the Chairman: Just before we close this particular question, I should like to point out that the charging of costs with depreciation on replacement value may at times severely handicap a manufacturer who has a plant which is old and in competition with a manufacturer of similar goods using a modern plant and improved equipment. About the only advantage the older manufacturer has is his lower cost of depreciation which is to his advantage and which he may use to offset the greater efficiency of the newer plant, so that, except where it is needed for comparison in a trade organization I think that the charge into costs of depreciation on cost itself is by far the better plan for the manufacturer. Of course I think Mr. Bell made it perfectly clear that in any event the surplus from appreciation woulde be reduced. We took that for granted to begin with."—Bulletin, NY.S.S. of C.P.A. Jan. 1931.
reproduction value, i.e. appraised sound value, may be and should be set up in the books of account; and (2) that the depreciation charge to operations should be based upon this figure.

These two conflicting points of view are well illustrated in the following quotations:

(1-a)

"I am distinctly orthodox. I can't see any problem at all. Your books should be kept at cost price figures. Never deviate in your ledger one iota from that basic principle, from the standpoint of the going concern as far as the preparation of a balance sheet is concerned.

"However, that does not prevent one, in conjunction with a correct balance sheet based on cost prices, and even then there are, of course, some elements of judgment entering therein, presenting along with it, if you care to, an expression of your opinion or the opinion of experts in that particular field, and thus give the public the benefit not only of the cost figure, but also indicate the present day replacement value.

"I am of the distinct opinion that the ledger should express cost pricing. There is no reason why we shouldn't have perhaps a double column in the balance sheet, one the actual cost figures, the other so-called present day values.

"When we get to the question of surplus, eliminating any consideration of legal points, it seems to me we are interested in profits. Our profits can only come from a sale that has been realized and, therefore, the only correct thing to do is the orthodox thing. Express the fifty thousand dollars\(^2\) as a deficit and if you want to say perhaps the property has been enhanced in value to offset this deficit, let us know that one is an actual operating deficit and the other is due to local conditions.\(^3\)"

(1-b)

"We are assuming that this is an honest appraisal, reflecting present values of construction of these properties. Try to buy the property now at a lower figure and see whether you can do it. Those are the values you have to deal with as a business man. They are present values. You are dealing today with the present business world all the time. Your accounts receivable are on the basis of present values. All the other things are on the basis of present values. Your payroll is on the basis of present values of labor. Throughout the entire institution you are buying and selling things on the basis of present values. Why pick out this one thing, property, and say, 'Well, we will give that merely the value we paid ten, fifteen, or twenty years ago,' and try to conduct business today, in 1929, on the basis of 1902 values.\(^4\)

1. Other bases of valuation are not discussed herein.
2. The problem under discussion was: A company has an earned surplus of fifty thousand dollars and a surplus from a revaluation, following an appraisal, of one million dollars. If it is legal for this corporation to pay a cash dividend from any existing surplus, whether earned or merely accumulated through appreciation, and if a dividend of one hundred thousand dollars is declared and paid, should there be shown on the balance sheet a deficit in respect to earned surplus, or should the two types be combined into one account, showing a net surplus?
4. Ibid.
(2)  

(a) "To bring about a better recognition by the investing public of the fact that the balance sheet of a large modern corporation does not and should not be expected to represent an attempt to show present values of the assets and liabilities of the corporation.

(b) "To emphasize the fact that balance sheets are necessarily to a large extent historical and conventional in character, and to encourage the adoption of revised forms of balance sheets which will disclose more clearly than at present on what basis assets of various kinds are stated (e.g., cost, reproduction cost less depreciation, estimated going-concern value, cost or market whichever is lower, liquidating value, et cetera)."\(^1\)

(3)  

"The controlling purpose in the valuation of assets subject to depreciation is not so much the statement of accurate values for use in the balance sheet but rather such a distribution of the depreciation charge as will spread the cost of the depreciating asset most equitably over the product turned out by the asset. It is the operating rather than the balance sheet point of view which should govern."\(^2\)

(4)  

"Accountants are properly skeptical of valuation bases other than original cost. But when the weight of evidence tends to show that some higher or lower basis is really more significant they are not unwilling to revise valuations. Outlay cost is a real thing. So, too, will replacement cost become a real thing when it is incurred. But because prices of equipment fluctuate, because there are always many alternative ways of getting service and because the amount and kind of service needed in an enterprise change with its selling opportunities - because of all these extremely exclusive matters, it requires a good deal of positive evidence to show on which side of experienced cost per unit of service a future unit cost is likely to lie. It must be emphatically repeated, however, that there is no real merit in an original cost, as such, to serve as a datum point for revaluations. On the other hand, it must be as emphatically asserted that adequately to consider possible future substitutions is as difficult and expensive a task as a redesigning of all plant and fixed equipment. Cost of reproduction new\(^3\) (of existing agencies) less an allowance for depreciation may be a good working rule in damage suits; it is absurd as a sole rule of going-concern value."\(^4\)

3. It must always be realized that valuations on a cost of replacement in kind basis may lead to ridiculous impractical results as when, for example, unused or unadapted or obsolete assets are so valued. So also the same pitfall is present if the material out of which the asset is made is so high priced that the asset is no longer made of that substance. Finally it must be emphasized that there is usually a wide variance between "cost of replacement in KIND" and "cost of replacement of IDENTICAL SERVICE".
"The so-called law of single price tells us that this marginal price is the one which prevails over the entire market. In other words, all producers can (and do in the long run), no matter what their relative facilities for producing a given commodity or service, collect from their customers, not an amount equal to their individual expenses of production, but one equal to those (plus interest and normal profits) of the marginal producer. Over the whole field there are producers operating plants of varying ages, acquired at different costs. Under the laws of marginal cost and single price it will be the cost of operating the new plants during a period of rising (or falling) prices that will be price-determining. The producers operating plants purchased at lower price levels will be recovering in revenue as many dollars per unit of service rendered as those producers operating equivalent plants purchased at the existing higher level of prices, or vice versa. This means that, roughly, each producer is collecting from the consumers an amount sufficient to maintain original investment in purchasing power—that each is recovering not cost, but an amount presumably sufficient to replace assets. In regard to replacement of assets, then, it matters little in the ultimate analysis whether the producer charges depreciation on the basis of replacement cost or on original cost. It seems clear that under normal long-run conditions the consumer does pay for replacement. It does not follow, however, that depreciation should be based on replacement cost rather than actual cost."¹

"We cannot agree with the conclusion that appreciation should not be recognized in the books of account. To take the position that closed transactions only are entitled to recognition is to narrow the function of accounting unduly and gainsay many of the well-settled practices. In our opinion, every effort should be made to increase the usefulness of accounting by constantly seeking to find additional data to which expression may be given in financial statements; to refine the data and make them more understandable; to make accounting increasingly more serviceable as a basis for administration."²

"The adoption of the completed-transaction theory of income has forced the accountant into a rather embarrassing position with reference to the valuation of his balance sheet items. In keeping with the double-entry process the accountant has thought it necessary to tie his income statement to the balance sheet. This has resulted in a rather artificial showing of values on the balance sheet and an attempt on the part of the accountant to justify this method of showing values as proper for a going concern."³

622. Depreciation vs. Depletion.—The term depletion is applied to those wasting assets, which become a part of the whole of the very product itself. Thus, a coal mine is subject to depletion, to the extent that the coal is removed from it. Other common assets subject to depletion are forests, quarries, oil wells, and ore mines.

623. Depreciation vs. Appreciation. We have already noted that it is often permissible and even advisable for a business to record the results of an independent appraisal when it has been made by a reputable appraisal company. At this point our chief concern is to show that appreciation should not be made to offset depreciation. The two are entirely different things and must be shown separately. Thus a building may appreciate in value due to a rise in cost of building materials and labor, and yet at the same time and totally independent of it, depreciation is taking place, for assuredly the building is wearing out both from the action of the elements and from the wear and tear of all who enter it. In brief, for every depreciable asset there must always be a current depreciation charge to the cost of operations, irrespective of the manner or the amount of the appreciation of it which has occurred during the same period of time.

624. Causes of Depreciation. In the case of tangible properties there are three main causes of depreciation; namely, (1) physical (2) functional, and (3) contingent.

(Physical Causes) From what has preceded, it should be obvious to the reader that depreciation is not synonymous with deterioration. The latter is a physical change, whereas the former is a bookkeeping allowance measuring, from the point-of-view of a going concern, the monetary decrease in value of an asset from one of the many causes now to be examined.

Deterioration, then, is a CAUSE of depreciation, and ONLY ONE of them. It arises (1) because of wear and tear, and (2) because of the action of time and of the elements. This latter is sometimes known as decrepitude; it is evidenced by rust, warping, rot, cracks and decay.

In this day of ours, the toll of wear and tear is nowhere more noticeable than in the case of the automobile. The effect of it upon the life of this particular asset is brought home to so many people, and with such tremendous force because of the short time within which it takes place, that it is universally recognized as the most effective factor causing PHYSICAL depreciation.

Decrepitude is another powerful deteriorating force, but in most instances it is not nearly as potent as wear and tear. However, the reader's attention is called to this statement which has appeared time without number in the different phraseologies of various writers on depreciation. "In fact, machinery deteriorates more rapidly as a rule when it is standing idle than when it is in use and is being properly cared for." In short, everything made by man is subject to the relentless ravages of nature. Nothing has yet been discovered or invented which can totally nullify its baneful effect. Few objects from ancient antiquity, not otherwise destroyed, have survived the scourge of rust, decay and rot.

(Functional Causes) Functional depreciation results from inadequacy (supersession) and/or from obsolescence. Whereas physical depreciation is caused by the reduction in the number (or portions thereof) of the service units of plant property, functional depreciation is caused by the reduction in their utility.

1. See also Appendix C, Sec. #19; and "A Solution to the Appreciation Problem"--Castenholz (LaSalle University Press)
2. To repeat, appraisals of fixed assets, not subject particularly to obsolescence, should be recorded if the change in value is material, definite, undisputed, and reasonably permanent.
3. In the opinion of some, FUNCTIONAL depreciation is more potent than PHYSICAL depreciation.
4. Accountants' and Auditors' Manual -- p. 64.
(Inadequacy) "In the case of inadequacy, the utility (of the asset) is lessened by a change in the demand made upon the property, due either to considerations of engineering economy, or unforeseen developments, or abandonment of original financial policy." That is, the asset becomes undersized for the new load placed upon it by the change in circumstances.

For example, it sometimes happens that through motives of economy, and/or conservatism, a structure or machine is erected or purchased which the owners fully realize they will have to tear down or replace if the business is as successful as they pray and hope it will be. Thus a new manufacturing company may know that a certain size and type of power plant will be needed to drive all of the machinery that will eventually be used, if its plans succeed. And yet, in the interests of present finances, present operating economy, and possible failure to expand to the size contemplated, it may decide to install another power plant more suitable to the needs of the PRESENT and immediate future.

A second cause of inadequacy arises from unforeseen developments. A certain product, for illustration, may seize the public's fancy to an extent not anticipated by even its best boosters. As a result, a number of small production units may have to make way for larger, i.e., more economical ones.

So also the abandonment by an enterprise of its original financial policy often causes supersession. This is apt to happen when there is a change of ownership, for the new capitalists frequently have set their eyes on wider business horizons than did the original proprietors.

(Obsolescence) As the writer sees it, the obsolescence of a production asset may be due to one of at least five distinct causes. First, there is that type which results from an advancement in the art of constructing the very production unit itself. Thus locomotives and steamships often became obsolete because of the rapid strides that were made in the art of building them.

A second cause of obsolescence is the cessation in demand for a commodity. For example, many specialized pieces of production equipment in carriage shops became worthless when automobiles replaced horse drawn pleasure-vehicles. The same sort of experience has been witnessed by many other trades, especially those engaged in the making of women's apparel.

Sometimes obsolescence is brought on by the discovery of a completely new process of production. No advance has been made in the art of constructing the existing production unit, neither has any adverse change taken place in the demands of the public for the commodity produced. It is simply a case of the march of progress, wherein a totally different and more economical method of production calls for entirely different production machinery. Indeed, it has been said of The General Electric Company by the editor of a New York daily that it has inventions, either on hand or in sight, the effect of which if released indiscriminately would be to relegate to the scrap heap countless millions of dollars worth of practically new machinery and equipment. In brief, the present advance of science is so swift in certain departments that in some respects it would be better for us if it could be somewhat retarded.

Another cause of obsolescence has often left its blight on fixed, specialized mining equipment. Indeed, mining history is said to be replete with instances where such machinery, located in mines operated by extracting the mineral under great difficulty and in scant proportions from its ore,
has become valueless shortly after the discovery in other parts of the globe of rich ore beds of practically pure mineral.

Finally, municipalities and regulating commissions have sometimes forbade the further purchase or erection of certain types of units, with the result that existing units have had to be abandoned in the interest of economy long before they otherwise would have been if the same type of unit could have been continued. Thus a new fire ordinance may forbid the future erection or expansion of wooden structures within a certain downtown area. As a consequence, the owner of a comparatively small frame building in this rapidly growing business section will find it necessary to tear the structure down if he is to erect the size of building which is commensurate with the tremendous increased rental value of his land.

(Contingencies) The causes of contingent depreciation are customarily outlined as follows:²

<table>
<thead>
<tr>
<th>Contingent Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Accidents</td>
</tr>
<tr>
<td>(a) Malicious Acts</td>
</tr>
<tr>
<td>(b) Negligence</td>
</tr>
<tr>
<td>(c) Elements</td>
</tr>
<tr>
<td>(d) Structural Defects</td>
</tr>
<tr>
<td>2. Diseases</td>
</tr>
<tr>
<td>(a) Electrolysis</td>
</tr>
<tr>
<td>(b) Crystallization</td>
</tr>
<tr>
<td>(c) Growths</td>
</tr>
<tr>
<td>(d) Parasites</td>
</tr>
<tr>
<td>(e) Parasites</td>
</tr>
</tbody>
</table>

(E.G.-If improvements are made on leased land,
3. Time --( the term of the lease may control the rate
   of depreciation.

(E.G.-In some instances the rate
4. Diminution in Supply- of depreciation is controlled
   by the rapidity with which a
   Natural resource is being
depleted.

As can be seen, these factors are not always present, but in many enterprises their destructive effect is clear-cut and definite. For example, during the rainy season a certain amount of loss from washouts is expected by Southern railroads. Likewise, ocean wharves suffer the ravages of algae and other marine life.

625. Treatment of Inadequacy.--As we have seen, inadequacy which comes about either through an abandonment of the original financial policy, or through an unexpected expansion of the market, or because of external forces or authority, is generally totally unforeseen. Therefore, is it not practical to make provision for any one of them via an enlarged annual depreciation charge. At best they can only be thought of as representing those more or less vague contingencies against which the most successful managements customarily provide a Reserve for Contingencies. However, the first two have a silver lining to them, which other types of charges to this

1. It is assumed that if the ordinance did not exist, this building could be added to instead of being torn down.
reserve may not have. That is, they are not necessarily sheer losses since they are incurred with the full expectation of their being recouped. For this reason some auditors favor carrying them (the losses) forward as deferred charges. In the writer's opinion it is not ordinarily proper to do so, but if they are, the auditor must insist (1) that they appear on the balance sheet under a separate description caption, (2) that they be written off in very short order, and (3) that they be fully commented on in the report, or, when none is rendered the full expectation of the auditor's Certificate. If the auditor does one whit less than this, he is jeopardizing his trust to the public.

On the other hand, inadequacy which can be reasonably foreseen, such as in the case of the aforesaid power plant (sec. 624), should be provided for by means of current charges to operations.

626. Treatment of Obsolescence.1—In the second of the above definitions of depreciation (sec. 616), there were these very significant words, "and the physical process rarely happens to be more rapid than the economic." For many businesses this is an accurate portrayal of the facts. But to the executives of some of these very industries, the need of ascertaining and making a reasonable provision for this obsolescence is too visionary. In their opinion it is only an academic question; a subject particularly suitable for theorists to speculate about.

On the other hand, practical engineers tell us auditors that they can forecast the future in this respect with usable certainty. For example, Kester gives a quotation which says: "Those most familiar with the art know the units which will be able to serve their entire physical life, and what classes are so uneconomical or otherwise defective that some improvement must be expected." Furthermore, both courts of law and public utility commissions have given numerous decisions that take full cognizance of obsolescence. Therefore, it seems rather clear that there are a great many instances where the effect of obsolescence can be and must be gauged and recorded as a periodic operating expense if the books of account are to be worth their keeping.2

627. Treatment of Contingencies.—As we have already noted, accidents are due to malicious acts, negligence, the elements, structural defects, and other similar causes. Unfortunately these causes are likely to be with us until Doomsday. Although prevention of accident campaigns have materially reduced the number of accidents wherever they have been

1. See Appendix C, Se. 16.
2. "Depreciation goes on whether plant is used to capacity or partially idle. Very little of the plant, except the land on which it is located, remains until used up or worn out; more is replaced by buildings and equipment which are superior or better adapted to the job to be done. A manufacturing organization's progress may be measured to some extent by the rapidity of its change in plant, bringing about better methods, improved quality of products, and lower costs. With lower costs come reduced selling prices, followed by increased business, and a greater use of plant. When plant value is low on the books, management is more responsive to the introduction of new methods and better tools."—1931 Annual Report, General Electric Co., p. 9.
run, "a certain amount of loss by accidents is seemingly unseparable from business, and no amount of care and precaution will entirely eliminate it." In fact, in very large enterprises, such as railroads, past records show that these accidents occur with considerable regularity. Indeed, the yearly loss is so nearly equal that the executives of some of these businesses maintain that essentially accurate operating results are obtained by charging the cost of accident repairs to the period in which they occur. While there is more than a grain of truth in this contention, the weight of opinion undoubtedly is that there is sufficient variation in these yearly expenses to warrant handling the costs through depreciation (or other) allowances. This is evidently the conclusion reached by the Interstate Commerce Commission which has required the adoption of this procedure.

In the case of accidents from the elements, these should be provided for in many instances by a periodic charge to operations, unless they are taken care of by ample sprinkler, flood, explosion, tornado, fire, earthquake, cyclone, and other similar insurance. Naturally, both the locality in which the business is situated, and the nature of the business itself will dictate what kinds of insurance are advisable. Thus, a business in New England is free from the destruction of cyclones and tornadoes, whereas a concern in certain areas west of the Mississippi displays good judgment in carrying this type of insurance. Likewise, a powder plant or a fireworks factory obviously needs explosion insurance, whereas a weave shed is totally immune from such an expense.

In short, based upon the law of averages a concern may definitely know that it has certain inevitable types of accident losses to meet each year or during the course of a period of years. Therefore, this loss, or more accurately speaking, expense, should be taken care of by a regular charge to operations, and the credit may just as well as not be included in the depreciation allowance account. On the other hand, rare and unforeseen accident losses should be covered by a provision set up direct from surplus.

626. "Engineers' Viewpoint" vs. "Accountants' Viewpoint."-- In double entry bookkeeping every business transaction or value fluctuation has at least a two-fold effect. This point of view is useful in analyzing the nature of a depreciation entry. Obviously, the debit becomes a charge to operations, whereas the credit results in an increase in a valuation reserve. The one affects the profit and loss statement; the other, the balance sheet. Thus depreciation may be looked upon mainly as a problem in the determination of correct costs of doing business, or, on the other hand, mainly as a problem in fixing the correct valuation of depreciable fixed assets for presentation in the balance sheet.

If the "accountants' point-of-view" prevails, the periodic depreciation charge to profit and loss will be determined solely in such a way that each unit of product will be charged with an equitable share of the cost of the plant assets used up in producing it. This program is clearly at odds with that usually taken by engineers who invariably estimate depreciation on the basis of the operating efficiency of the assets. This is essentially a balance sheet valuation viewpoint.

1. "It is of interest 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."--by The Committee on Terminology of the A.I.A. 2--The writer, however, believes that a separate allowance should be established so that the accuracy thereof may be gauged more closely than if it were entered in the depreciation reserve.
629. "Financing Viewpoint!"—Another prevalent idea of depreciation is that it is a means of financing the replacement of an asset. That is, that profits are charged and thereby reserved, exactly as a Reserve for Extension of Plant is created out of surplus. In addition, there is usually present in the mind of the one who advocates it, a vague notion that this provision also insures a satisfactory cash position wherewith to replace the asset at the time of its retirement. Curiously enough, this obsession persists even when no definite depreciation fund has been created. Sometimes, however, the management goes the whole distance of its erroneous conclusions by creating this fund.

The above plan has, of course, nothing whatever to recommend it. The charge for depreciation is an expense, not a distribution of profits. The allowance account is simply a part of the net credit side of the asset account to which it relates. It is NOT an appropriated surplus account.

Furthermore, those concerns which look upon depreciation from this financing angle usually provide generously for it in bumper years, but scantily in lean years. Thus the plan is simply one whereby the allowance is built up at random during the life of the asset to the parity of the net asset value. No thought whatever is given to the effect which these sporadic charges must have upon the valuation of the assets during the meantime, nor upon the costs of the several operating periods. The chief concern of its proponents is to use it as a "variable factor" in juggling profits to the desired amount, insofar as this is possible by these arbitrary charges.

630. Repairs.—If deterioration is the effective cause of depreciation, the concern's policy in regard to repairs and maintenance is one of the largest single factors that must be taken into consideration in determining the proper depreciation rates to be applied to the several types of plant properties.

When machinery, for example, is given proper care, its efficiency is not only maintained at a higher level than otherwise, but its life is also extended much longer than one might suppose. These facts are well recognized by those concerns which have a small maintenance crew whose sole duty is to oil, repair, and regulate the machinery, shafting, motors, pulleys, and other equipment. These men not only make minor repairs and adjustments, such as tightening nuts to eliminate excessive play, replacing lost or rusted cotter pins to prevent accidents, renewing nearly worn out bushings, gears, etc., to forestall short shut-downs for repairs during working hours, but also turn in written reports to their department on the more substantial repairs, adjustments, and replacements which need attention immediately or in the near future. These are undertaken, in the night, or during the noon-hour if the requirements are very urgent. A few concerns also make a practice of shutting down certain departments once a week at a half hour or so before closing time, so that the operators can oil, clean, and adjust their machines, as well as sweep the floor and wash the windows.

Even when this excellent program is in force, it is recognized that there may be some deferred maintenance due to either a temporary lack of funds, the inadvisability of shutting down in the midst of a rush order which calls for a 24-hour-a-day operating program, or the impossibility of immediately getting a certain special part or service, etc.
On the other hand, most factories operate their machinery without having any definite policy in regard to its proper maintenance. Needed repairs and adjustments are disregarded until the machine stalls or breaks down. Maintenance crews are totally unknown, and shut downs for cleaning up are regarded as sheer losses.

631. Allowance for Deferred Maintenance. 1—The customary method of handling repairs is to charge their cost to the period in which they are made. The accuracy of this procedure, so far as the profit and loss statement is concerned, is based on premises that these charges are approximately equal from period to period. This assumption is clearly incorrect for a new concern, and is only approximately true even for a very large plant "which has reached its gait." In the latter instance, it is customary to maintain that the annual charges must of necessity be fairly equal because the depreciable assets are of various life and in all stages of deterioration. This conclusion may be true in certain rare instances, but it is not per se true. As to the balance sheet, the method is never correct since it does not provide any allowance for deferred maintenance of which there is always some even under the most watchful maintenance supervision.

A second method requires a careful estimate of the probable cost of the repairs that will be made during the lifetime of each asset. This amount is then set up year by year on a proportional basis in an Allowance for Deferred Maintenance Account, the charges being to Repairs and Maintenance Expense. The actual expenditures for repairs are, therefore, chargeable to the allowance account. Thus, during the first year of use of a machine, operations are charged with the cost of the service really rendered, even though the actual repairs caused by this wear and tear are not made good until the second or third year. Obviously, if the repairs can be satisfactorily estimated in advance, and herein lies its chief weakness, this method is the soundest both in regard to the balance sheet and the profit and loss statement.

A third method is merely a variation of the second, wherein the debit is included with the regular depreciation charge and the credit is made to the Allowance for Depreciation. Although this method has been used satisfactorily, the weight of opinion is that the use of two allowances gives the best results, since it discloses each factor separately. For balance sheet presentation, however, they should be combined.

In closing this section, it may be stated that "it is not generally customary to set up a reserve for repairs on the books, because of the difficulty encountered in estimating what the reserve should be, and because to a certain extent major repairs do not all fall in the same year. The steam plant may require overhauling one year and the roof the next year. All that the auditor is really bound to do is to see that all liabilities incurred for repairs actually made are set up." 2

1. " . . . . . This calculation tends to set to rest fears that much of the reduction [in expense] has been at the expense of maintenance which must eventually be restored, if proper service is to be kept up."—J.R. Brackett, Detroit News, March 29, 1932, p. 34.
2. Eggleston, p. 158.
632. Local Conditions.--Surprising as it may seem, it is nevertheless true that even those who are in very close contact with the problem of depreciation fail to realize that the rate of physical depreciation is affected by local conditions. This shortcoming is splendidly illustrated in the following excerpt from a decision of the U. S. Board of Tax Appeals.1 "Which method results in petitioner having the reasonable allowance provided for by statute? The method of the petitioner which takes into account all factors having an actual bearing upon depreciation—the facts and circumstances peculiar to each year (Note:—production of steel in 1915 was 93,000 tons; in 1916, 351,000 tons) or the method of the Commissioner (straight-line basis) which apparently gives no consideration to such actual facts, but, instead, is based upon a theoretical and mathematical formula? We are of the opinion that the method used by petitioner, of establishing the depreciation actually sustained during the years in controversy, is more accurate and reasonable than the one used by the Commissioner."

A review of this problem of the proper rate setting will show that the term of a lease, the presence of contingencies, obsolescence, or inadequacy, the size of a natural resource including the rate of its depletion, the repair policy, the climatic conditions, the type of water supply, the class of help, the normal load, and the normal operating time are among the more common factors to be taken into consideration in adjusting rates taken from authoritative depreciation tables to usable rates for specific situations.

Another common fallacy is centered in the practice of either totally ignoring or taking full depreciation on an idle asset.2 Likewise, this charge is often arbitrarily treated as a cost of operations. In stating that no rule can be given which is applicable even to most instances, the writer is not making a criticism and then evading the duty of presenting a constructive solution. He is merely stating the actual facts. For example, if a new addition to a building is not being used, because the original plans have temporarily fallen through, the depreciation charge is not a cost of operations. It is a loss. Furthermore, the full depreciation rate, applicable to the building when in use, should not be taken, but some rate should be applied for there is physical depreciation from the action of the elements. On the other hand, a certain machine may be purchased with the full knowledge that it will be idle about 40 per cent of the year. In this instance the cost of the idleness is a bona-fide charge to operations.

Likewise, the depreciation rate for a two or three shift program is not necessarily twice or thrice that properly applicable to one shift. Ordinarily it will be considerably less than a proportional increase; in some instances, however, it may be decidedly more. This in an actual case the Rulings Board of the Finance Division of the Bureau of Aircraft Production determined upon rates of 2 1/2, 3, and 4% for a brick and concrete building used for manufacturing on a one, two, and three shift program of eight hours each. Under the same conditions certain machinery was depreciated 7 1/2%, 10 and 12%, and furniture and fixtures at 10, 12 1/2 and 15%.

2. If the asset is subject to obsolescence, full depreciation must be taken during the idle periods. On the contrary, the writer believes that if the repairs and maintenance are grossly neglected, the auditor MUST set up an adjustment for it.
Obviously, the corrosion, warping, rot and decay of the roof, the foundations, the walls, and other portions of a structure which are subject to deterioration by the elements, are not affected by the number of shifts. On the other hand, those portions of the building which are subject to depreciation from vibrations, load, strain, wear and tear, etc., are adversely affected by the longer working hours. Hence, the composite average rate for the building as a whole is naturally much less than a strict proportional increase.


Definitions and Symbols

(1) Original cost includes not only the invoice price but also all costs of getting the asset in place ready for service. Freight, insurance, haulage and erection costs are among the more common additional expenditures.

(2) Service life is the period time during which the asset will be used. Ordinarily this will be measured in years, but under certain methods it will be stated in service hours or in units of output.

(3) Salvage value\(^1\) is the estimated selling price of the junked asset.

(4) \(C\) = Original Cost

(5) \(r\) = Rate of depreciation per period

(6) \(n\) = Length of useful life

(7) \(D_n\) = Depreciated cost value at the end of the last period, i.e., Scrap Value.

(8) \(d\) = Annual depreciation.

(9) \(K\) = Sinking fund contribution

(10) \(i\) = Interest rate

General

It should be clear from the foregoing sections of this chapter that of the several causes of depreciation, namely, wear and tear, decrepitude, inadequacy, obsolescence, accidents, diseases, time, and diminution in supply, only one of them can be the controlling factor in determining the proper rate of depreciation for a specific asset, and this effective cause is obviously the one which is the most rapid of them all. Likewise, we have seen that where deterioration is paramount, the client's policy in regard to repairs and maintenance must be ascertained, as well as the normal number of working hours and other special local factors, before the rate can be set with any reasonable degree of accuracy. Furthermore, if the scrap value is worth taking into consideration, an estimate must be made of the asset's future junk price at the time of retirement. Involved in this estimate is a consideration of the effect of inadequacy and obsolescence upon this future value. In short, the element of judgment enters into the computation of a depreciation rate far more often than do definitely known facts.

One other point needs to be driven home, and that is that no one method of depreciation is satisfactory for all situations. Therefore, in

\(^1\) If the demolition cost is sizable, this also must be provided for through the current depreciation charges, the credit being to a suitably named liability account.
discussing the various depreciation methods, their merits and disadvantages will be pointed out in the abstract. Hence, what may be said herein to be an inherent disadvantage of a particular method may actually be a fine recommendation for it in regard to a certain specific case that the reader has in mind, and vice-versa.

(a) Straight Line Method.—Under the straight line method of figuring depreciation, the net cost of the asset is spread evenly over the estimated useful life of the asset. The formula for this method is:

\[
\text{annual depreciation} = \frac{\text{Cost} - \text{Scrap \ or \ in \ symbols, \ } d = C-Dn}{\text{Useful Life}}
\]

for a 20 year asset costing $10,000 with a scrap value of $500, the annual charge is $475, i.e., $10,000 - $500 \div 20. As it is always easier to keep track of depreciation in terms of per cent of cost, this figure should be secured by dividing the annual depreciation by the cost; thus, \[
\frac{475}{10,000} \text{ equals } 4.75.\%
\]

Straight line depreciation is, of course, about the easiest and simplest method possible. As it spreads the depreciation cost on a time basis equally over the service life of the asset, it gives satisfactory results where time is the effective cause of depreciation. It is also commonly used when the rate of production output is fairly equal from year to year.

On the other hand, attention must be called again to the necessity of considering the item of repairs and maintenance in conjunction with the selection of the proper method of depreciation. Under an ideal situation the sum total expense of both the repairs and the depreciation will be equal from period to period under a constant operating output. As the actual repair bills for an asset are lightest during the first years of service and heaviest near the time of retirement, the amount of the periodic depreciation charge should be vice-versa in order for the total of these two expenses to approach the aforesaid periodic constant charge.

Although the above conclusions are admittedly correct for an individual asset, it is often maintained that where the plant properties are sizable and in all stages of depreciation, the heavy repair bills on the old assets negatives the "free use" of the new assets, so that the cost of the actual outlay on repairs is approximately the figure that would be secured if the repair expense was handled on a theoretically accurate basis via a Reserve for Repairs and Maintenance. Perhaps this contention is true in certain instances, but it is not per se true of all large plants. And certainly it is not true of small concerns, except by the rarest coincidence.

(b) Service Output Method.—When this method is used, an estimate must be made of the number of units of output which the asset will turn out before it must be retired. Thus a freight car’s service life would be stated in car-miles, a loom in terms of yards of cloth, and so on. On this basis the periodic depreciation charge is obviously that portion of the net cost of the asset which the current output bears to the total expected output.

As a rule, this method is the most equitable of all the depreciation methods, because each unit of product is charged with the same depreciation cost as every other unit no matter whether production is slack or rushed. On the other hand, it should be recognized that the method is not applicable to an individual machine performing several different processes, or the same process but to a different extent on different units of product. Thus the wear and tear on a loom is not the same for every yard of cloth produced by it, but varies considerably with the different styles and grades.
(c) Fixed-Percentage on Diminishing Value Method.—This plan calls for the taking of a fixed per cent of the diminishing value of the asset as the current depreciation charge. Hence, for a $30,000 asset the amount is $3,000 for the first year if the rate is 10%, and $2700 ($30,000 minus $3,000 times 10%) for the second year. If the salvage value is worth considering, the problem of ascertaining the proper per cent necessary for writing off the asset within its useful life is somewhat complicated. Using the symbols adopted herein, the formula is derived as follows:

\[
D_1 = C - rC = C (1-r) \\
D_2 = D_1 - rD_1 = C (1-r) - rC (1-r) = C - Cr - Cr^2 = C(1-r)^2 \\
D_n = C(1-r)^n
\]

Solving for \( r \) by taking the nth root of each side, we have

\[
r = 1 - \sqrt[n]{D_n} \quad ; \quad r = 1 - \frac{n}{V} \frac{\text{Scrap Value}}{\text{Cost}}
\]

**PROBLEM**

(assumptions)

(1) The asset costs $5,000
(2) The service life is 5 years
(3) The scrap value is $100

**SOLUTION**

\[
r = 1 - \frac{5}{5000} = 54.27\%
\]

<table>
<thead>
<tr>
<th>Age in Yr.</th>
<th>Rate of Depr.</th>
<th>Annual Depr.</th>
<th>Depr. Value</th>
<th>Reserve For Dep</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>54.27%</td>
<td>2713.50</td>
<td>2286.50</td>
<td>0</td>
</tr>
<tr>
<td>1</td>
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<td>1240.88</td>
<td>1045.62</td>
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</tr>
<tr>
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<td>567.46</td>
<td>478.16</td>
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</tr>
<tr>
<td>3</td>
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</tr>
<tr>
<td>4</td>
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<td>118.67</td>
<td>100.00</td>
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</tr>
<tr>
<td>5</td>
<td>54.27%</td>
<td></td>
<td>4900.00</td>
<td></td>
</tr>
</tbody>
</table>

As can be seen, this method calls for heavy depreciation during the first years of use when (1) the efficiency (i.e., output) of the asset is at its maximum and (2) the actual repair bills are least. Hence the tendency of this plan, when combined with the cost or repairs as incurred, is to equalize these two costs over the life of the asset. It should be realized, however, that there is no "magic charm" or "inherent goodness" in this mathematical formula which makes it preferable to less "scientific" methods. In fact, when the life of the asset is short and the salvage small, as above, the charges under this plan are usually decidedly too heavy for the first years.
(d) Composite Life Method.--Unfortunately for all concerned, most businesses do not maintain a property ledger, but carry the production assets in four or five property accounts in the general ledger. Most common among these are Buildings, Machinery, Auto-Trucks, Tools, and Furniture and Fixtures. By properly combining these several accounts on a weighted basis, the composite life of the plant can be ascertained. The "mean life" thus obtained is not to be used as a working figure by which to compute an annual lump sum depreciation charge for the creation of a single reserve for depreciation, but rather as a check or proof number. The individual reserves should always be maintained, one for each depreciable property account in the general ledger, and the sum of these should approximate the amount obtained by using the composite life figure.

EXAMPLE

(assumptions)

(1) Buildings: life 50 years; cost $51,000; scrap value $1,000
(2) Machinery A: life 10 years; cost $11,000; scrap value $1,000
(3) Machinery B: life 5 years; cost $12,000; scrap value $2,000
(4) Office Equipment: life 10 years; cost $4,100; scrap value $100

SOLUTION

Method A

<table>
<thead>
<tr>
<th>Asset</th>
<th>Life</th>
<th>Cost</th>
<th>Scrap</th>
<th>Depr. Value</th>
<th>Times Replaced</th>
<th>Total Expense</th>
<th>Dollar Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bldgs.</td>
<td>50</td>
<td>$51000</td>
<td>$1000</td>
<td>$50,000</td>
<td>5</td>
<td>$50000</td>
<td>$250000</td>
</tr>
<tr>
<td>Mach. A</td>
<td>10</td>
<td>11000</td>
<td>1000</td>
<td>10,000</td>
<td>10</td>
<td>50000</td>
<td>500000</td>
</tr>
<tr>
<td>Mach. B</td>
<td>5</td>
<td>12000</td>
<td>2000</td>
<td>10,000</td>
<td>5</td>
<td>100000</td>
<td>500000</td>
</tr>
<tr>
<td>Office Equip.</td>
<td>10</td>
<td>4100</td>
<td>100</td>
<td>4,000</td>
<td>5</td>
<td>20000</td>
<td>200000</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td>$78000</td>
<td>$4100</td>
<td>$74,000</td>
<td></td>
<td>$220000</td>
<td>$370000</td>
</tr>
</tbody>
</table>

220000 divided by 3700000 = 5.95% 3700000 divided by 220000 = 16.82 yrs.

Method B

<table>
<thead>
<tr>
<th>Asset</th>
<th>Life</th>
<th>Cost</th>
<th>Scrap</th>
<th>Depr. Value</th>
<th>Rate of Depr.</th>
<th>Depr. per year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bldgs.</td>
<td>50</td>
<td>$51000</td>
<td>$1000</td>
<td>$50,000</td>
<td>2</td>
<td>$1000</td>
</tr>
<tr>
<td>Mach. A</td>
<td>10</td>
<td>11000</td>
<td>1000</td>
<td>10,000</td>
<td>10</td>
<td>1000</td>
</tr>
<tr>
<td>Mach. B</td>
<td>5</td>
<td>12000</td>
<td>2000</td>
<td>10,000</td>
<td>20</td>
<td>2000</td>
</tr>
<tr>
<td>Office Equip.</td>
<td>10</td>
<td>4100</td>
<td>100</td>
<td>4,000</td>
<td>10</td>
<td>4000</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td>$78100</td>
<td>$4100</td>
<td>$74000</td>
<td></td>
<td>$4400</td>
</tr>
</tbody>
</table>

4400 divided by 74000 = 5.95% 74000 divided by 4400 = 16.82 years.

1. When the method is applied to the various items in a SINGLE account, such as machinery, the composite life figure is often fairly reliable as a basis for ascertaining the lump sum depreciation charge.
(e) Working Hours Method. — When this depreciation plan is adopted, the life of a production asset is estimated in terms of working hours. The annual depreciation charge for a machine becomes, therefore, that portion of net cost which the number of current machine working hours bears to the total possible working hours. Hence if a machine is operated 700 hours out of a total life of 21000 hours, 1/30 of the net cost will be written off. In short, operations are charged with depreciation on the basis of the intensity of use, provided (1) that the normal speed of the machine is maintained so that the output is always the same, say 50, an hour, and (2) that (in the case of a machine which does the same process on different articles of output) an hour's use in connection with the production of article "M" is no more destructive to the machine than an hour's service on article "R". If these two latter conditions are not present, the method needs adjusting, but otherwise it gives satisfactory results.

(f) Sum of Expected Life-Periods Method: — This method also goes under the name of "Changing Percentage of Cost Less Scrap", i.e., the base remains fixed, but the periodic rate varies. The formula can be best explained through an illustrative example. Thus for an asset with a life of ten years, the sum of the expected life-terms at the beginning of each successive period is 10 plus 9 plus 8 plus 7 plus 6 plus 5 plus 4 plus 3 plus 2 plus 1 = 55, and the respective yearly rates of depreciation are 10, 9, 8, etc. Due to the ease with which these rates are obtained, it is not surprising, therefore, that this method is often used in place of the fixed-percent on diminishing value plan. See (c) above.

As in the case of the aforesaid plan (section c), this method also provides for heavy depreciation during the first years of use when the actual repair bills are light, hence in certain instances it has been found to be satisfactory. On the other hand, it is obviously poorly adapted to the needs of those concerns whose output varies widely from period to period, or whose method of handling the repair and maintenance expense is via an allowance account.

(g) The Fifty Per Cent Method. — Those who use the fifty percent method maintain that for certain classes of assets, particularly those which are numerous, of small value, and short lived, such as hand tools for example, there comes a time in the course of a few years when these assets are in all stages of depreciation from 100% to 0%. Hence, it naturally follows that after the allowance is built up to 50% during the first few years when the assets are more or less brand new, the future REPLACEMENTS are chargeable to expense. Of course, if any of the purchases represent ADDITIONS, they should be charged to the asset account if their value is material. On the whole, therefore, this plan often gives satisfactory results under the conditions named, even though it fails to capitalize the additional cost of an asset over the one replaced.

(h) The Maintenance Method. — Under this program the annual depreciation charge is made equal to the cost of maintenance of the assets for the year, hence the burden falls irregularly upon the several operating periods. As we have noted, actual repairs are slight during the first years of use and heavy along towards retirement. Moreover, during a rush period repairs must of necessity abide a more favorable time if they are not so pressing as to threaten an immediate breakdown. Thus a slack period 1. It may be interjected here that the rate for overtime work is not directly proportional to the standard rate. Thus Nicholson and Rohrback suggest an increase of 5% for each hour overnormal (8 - 10 hrs). Thus if the rate for machinery is 7%, the rate for a constant 14 hr. use is 8.4%.
following a busy one shoulders the double burden of the repairs and the depreciation which should have been borne by the preceding busy one. In short, the plan has nothing whatever to recommend it.

(i) The Replacement Method.--This method is based upon the assumption that after a large plant has reached its gait, the expending of renewals and replacements is sufficient to take care of all accruing depreciation. Moreover, its proponents contend that there is no such thing as accrued depreciation under a well regulated maintenance policy, and hence do not establish an allowance for depreciation even for the amount which most accountants recognize as the depreciation accrued up to the time, if any, of normal replacements and renewals. As hinted by the interjection, the writer doubts very much that the law of averages can be relied upon to smooth out the cost of renewals and replacements over the several operating periods.

(j) The Sinking Fund Method.--This method is based upon the assumption that a replacement fund is to be accumulated at interest, in addition to the creation of a depreciation allowance of the same amount. However, far more often than not, the fund is omitted, but the mathematical calculations are used to ascertain the annual depreciation charges.

The problem involved, then, is to find the periodic sum which put at interest will amount to the net cost of the asset by the time it is retired. Using the symbols adopted, the formula is:

\[ K = \frac{C-Dn}{(1 + i)^n - 1} \]

or

\[ \text{Cost} - \text{Scrap Value} \]

\[ \text{The amount of an annuity of } \$1 \]

Thus for a 5 year asset costing $1000, the annual charges are shown below in column 4, assuming an interest rate of 4\% and a scrap value of $25.

<table>
<thead>
<tr>
<th>Period</th>
<th>Interest</th>
<th>Contribution</th>
<th>Deprec. Charge</th>
<th>Reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>7.20</td>
<td>180.01</td>
<td>180.01</td>
<td>160.01</td>
</tr>
<tr>
<td>2</td>
<td>14.69</td>
<td>180.01</td>
<td>171.21</td>
<td>367.22</td>
</tr>
<tr>
<td>3</td>
<td>22.48</td>
<td>180.01</td>
<td>194.70</td>
<td>561.92</td>
</tr>
<tr>
<td>4</td>
<td>30.58</td>
<td>180.01</td>
<td>202.49</td>
<td>764.41</td>
</tr>
<tr>
<td>5</td>
<td>180.01</td>
<td>180.01</td>
<td>210.59</td>
<td>975.00</td>
</tr>
</tbody>
</table>

(If a fund is established, the entries therefor will be an annual debit to Depreciation Fund Cash and a credit to general Cash for $180.01. In addition, the annual interest on the fund (column 2) requires a debit to Depreciation Fund Cash and a credit to Interest Earned.)

Although these annual charges are determined with mathematical precision, they are not per se scientifically accurate for depreciation purposes. In fact, if anything, the results are "upside down", for, as we have seen, the depreciation charges should be gradually decreased to compensate for the increase in the actual repair bills, or, when the repairs are handled via an allowance, the depreciation charge should always be the same during periods of equal output.

(k) The Appraisal Method.--This method requires a physical appraisal of the plant properties to be taken at the end of each fiscal period, the net difference in the sound value of an asset between two successive appraisals being the amount of its depreciation for the period.
On the face of it, this method looks attractive, but as a matter of fact physical depreciation is not accurately discernible within such short intervals as a year let alone a single month. Moreover, as has been emphasized, the accountant is not concerned with the appraisal engineer's idea of depreciation, i.e., operating efficiency, but with the equitable proration of the net cost of an asset over each unit of product which it turns out. Furthermore, the cost of making annual appraisals is prohibitive; and there is apt to be too much attention paid to reproduction cost instead of original cost.

(1) The Gross Earnings Method.--This method needs first of all to be sharply differentiated from any plan based on profits; the two have no relationship whatever. Under this program, the annual depreciation is a certain fixed per cent of the gross earnings irrespective of the amount of net profits. The rate may be set on the basis of past experience, or, as the ratio of the net cost of the assets to the estimated gross earnings during the composite life of these assets. Or, stated in other words, the total depreciable cost is prorated over the various years on the basis of the ratio of the respective annual gross incomes to the grand total estimated gross income expected during the composite life.

When deterioration is the effective cause of depreciation, this method is often fairly satisfactory, provided also that the product is standardized and fairly stable in selling price, etc. Under these special conditions the gross income has a very direct relation to quantity of output so that due allowance is automatically made for varying degrees of intensity of factory operations.

(m) The Annuity Method.--The purpose of this method is to charge interest on the diminishing value of the asset into the cost of operations, as well as an increasing charge for depreciation. The chief objection to the method in the opinion of many auditors is that interest on the capital invested in the asset is not a cost of production. On the other hand, and generally speaking, efficiency engineers, cost accountants, and business men are among its most loyal advocates. As the writer sees it, the question is largely academic. If business men find that they can operate their businesses with costs figured in this manner, the auditor should not offer the slightest objection to it. However, he must either reduce the final inventories by the estimated amount of interest included therein, if sizable, or state that the inventories are so valued. This precaution is necessary, for interest is not yet so widely accepted as an element of cost that it may be called good auditing procedure to pass over its inclusion without mention.

The formula for securing the annual debit to depreciation expense, i.e. interest plus depreciation, is as follows:

\[
C = \frac{Dn}{(1 + i)^n} + d(1 - (1 + i)^{-n}) \]

or Cost = the present worth of the salvage value plus the present worth of an annuity of the real depreciation charges. Thus, for a 5 year asset costing $11,000 and having a scrap value of $1000, the total annual charge for depreciation and interest, on a 4% basis, is $2286.27, computed as follows:

\[
d = \frac{11000 - 1000}{4.45162} = \frac{11000 - 821.93}{4.45162} = \frac{10178.07}{4.45162} = 2286.27
\]

1. I.E. In long lived assets.
2. The appreciation, if any, is apt to be allowed to offset the depreciation.
634. Fully Depreciated Assets.—When a client does not maintain a property ledger, it usually adopts one of the two following methods. All of the assets of a particular type and similar life expectancy, such as machinery, are depreciated at a composite rate. Obviously, this provision is deficient for the shorter lived assets in the group, correct for others, and excessive for the "nonagenarians of the race." Therefore, it is quite common to proceed on the basis of charging each asset in full to the allowance account when it is retired, provided of course, that it "dies a natural death." If, however, it is retired because of an unexpected accident, for example, only the exact amount of the accrued depreciation written off to date is charged to the allowance, the difference being charged or credited to surplus. Thus, where the composite rate is 5%; some assets may be depreciated only 19 years, whereas others may be depreciated 21 years; but this fact will not change the method of charging the full net cost of the retired asset to the reserve. (Theoretically, salvage value and demolition costs should be taken into consideration, but in practice they rarely are unless the amounts are important.)

A second method requires the yearly additions to plant properties to be kept track of. These amounts (without diminution) are then depreciated for the number of years indicated by the depreciation rate used. When a production asset is discarded (whether before or after its supposed life) its salvage value, if any, may be credited to depreciation expense, but not adjustment is made at this time either in the allowance or in the asset accounts for the cost value of the asset. This elimination is eventually accomplished by charging the additions against the allowance when, and only when, they have become fully depreciated as a unit. Hence it is true that under this program, an asset which has exceeded its life expectancy will have been fully depreciated and charged off the books of account before it is actually retired. Likewise, on the other hand, a short-lived asset will be carried along on the books until the particular yearly additions in which it was entered on the records become fully depreciated.

635. See Plate 193.

636. Appraisals.—The propriety and soundness of placing appraisal values upon the books of account is still seriously questioned by leading accountants. Many of them believe that all requirements are amply met by placing the revaluation figures on the balance sheet either in a footnote or in a parenthesis following the names of the accounts. The decided weight of opinion, however, is that it is often desirable, and even necessary, to enter the appraisal in the ledger, provided the appraisal is made by a disinterested expert, provided the facts are properly disclosed to all concerned, and provided the portion of the increase in surplus which 1. However, when correctly analyzed, it should be seen that the term AVERAGE RATE means that it is the rate which will (should) provide the "exact" reserve for each asset BY THE TIME it is retired.

2. I.E. In ascertaining the depreciation rate.
is due to the general rise in price level is credited to capital surplus. This last proviso gives rise to the consideration of a very important fact which is apt to be overlooked; namely, that the surplus which arises from the excess of the appraised sound value over the existing net book value may be properly credited in part to earned surplus instead of wholly to capital surplus. In brief, past errors in bookkeeping, either in expensing capital assets, and/or in capitalizing repairs, and/or in providing excess or insufficient depreciation on cost should be reflected through earned surplus. This point is illustrated in the solution to the following problem.

**EXAMPLE**

(assumptions)

1. The appraisal report shows that machinery to the value of $100000.00 has been expended.
2. Depreciation to date on this asset is $4500.00 on the cost basis.
3. The depreciation rate in use of 5% is found to be correct.
4. Machinery $150000.00 $208000.00
   Depreciation Reserve 75000.00 103350.00
   Net $75000.00 $104650.00
5. The above machinery is only a portion of the total machinery, i.e. it is only the machinery which is subject to a 5% rate of depreciation.

(solution)

Machinery $58000.00
Depreciation Reserve-Machinery 28350.00
Earned Surplus 5500.00
Appraisal Surplus-Plant 24150.00
To adjust the book figures to the appraised sound value. Computations as follows:

<table>
<thead>
<tr>
<th></th>
<th>Cost Basis</th>
<th>Adjusted Cost</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>$150000.00</td>
<td>$160000.00</td>
<td>$10000.00</td>
</tr>
<tr>
<td>Allowance</td>
<td>75000.00</td>
<td>79500.00</td>
<td>4500.00</td>
</tr>
<tr>
<td>Net</td>
<td>$75000.00</td>
<td>$80500.00</td>
<td>$5500.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Cost</th>
<th>Appraisal Values</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>$160000.00</td>
<td>$104650.00</td>
<td>$48000.00</td>
</tr>
<tr>
<td>Reserve</td>
<td>79500.00</td>
<td>103350.00</td>
<td>23850.00</td>
</tr>
<tr>
<td>Net</td>
<td>$80500.00</td>
<td>$104650.00</td>
<td>$24150.00</td>
</tr>
</tbody>
</table>

(Note—Even from this short problem, it is clear that the necessary facts may not be available from the appraisal report, but if they are, it is essential that a careful division be made between earned surplus and capital surplus.)

1. If the cost of replacement is less than the original cost, that portion of profit which represents the excess of depreciation on cost over depreciation on replacement cost is NOT legally available for dividends.
2. Machinery 10,000.00
   Appreciation of Machinery 48,000.00
   Depreciation Reserve-Machinery 4,500.00
   Depreciation Reserve-Special - Machinery 23,850.00
   Earned Surplus 5,500.00
   Appraisal Surplus - Plant 24,150.00
EXPLANATION OF PLATE 195
FORM OF APPRAISAL SHEETS

635. Explanation and Comments.--(a) This is a summary sheet for a single building and includes not only the building proper and its equipment, but also all other depreciable property within its confines. Thus in this particular building there were factory office equipment, small motor trucks for internal hauling, shop equipment of various kinds, and other items not detailed. Notice also that the appraisal has been drawn up on an insurable and non-insurable basis.

(b) This is a representative sheet taken from a group of sheets on shop equipment. Only one item (rolling machine) is shown. The sub-sheets on a building often go into such detail as follows:

EXCAVATION
xx cu. yds. basement excavation at $xx = $xx

FOUNDATION
(1) xx sq. ft. forms for concrete at $xx = $xx
(2)
(3)

MASONRY WALLS
(1),
(2)
(3)

STEEL AND IRON
(1)
(2)
(3)

FLOORING
(1)
(2)
(3)
(a) A Summary Sheet

The Joyce Company
Grand Summary of Building FMB July 1, 1930

<table>
<thead>
<tr>
<th>DESCRIPTION</th>
<th>ORIGINAL Cost Allowance</th>
<th>REPRODUCTION Cost Allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BUILDINGS:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-insurable portion</td>
<td>xx xx</td>
<td>xx xx</td>
</tr>
<tr>
<td>Insurable portion</td>
<td>xx xx</td>
<td>xx xx</td>
</tr>
<tr>
<td>TOTAL</td>
<td>xx xx</td>
<td>xx xx</td>
</tr>
<tr>
<td><strong>BUILDING EQUIPMENT:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Elevators</td>
<td>xx xx</td>
<td>xx xx</td>
</tr>
<tr>
<td>Heating System</td>
<td>xx xx</td>
<td>xx xx</td>
</tr>
<tr>
<td>Lighting System</td>
<td>xx xx</td>
<td>xx xx</td>
</tr>
<tr>
<td>Fire Equipment</td>
<td>xx xx</td>
<td>xx xx</td>
</tr>
<tr>
<td>Plumbing</td>
<td>xx xx</td>
<td>xx xx</td>
</tr>
<tr>
<td>Telephone System</td>
<td>xx xx</td>
<td>xx xx</td>
</tr>
<tr>
<td>Miscellaneous Facilities</td>
<td>xx xx</td>
<td>xx xx</td>
</tr>
<tr>
<td>TOTAL</td>
<td>xx xx</td>
<td>xx xx</td>
</tr>
</tbody>
</table>

Omissions: xx xx xx xx

5 SHOP EQUIPMENT
(Details Omitted)

6 OFFICE EQUIPMENT
(Details Omitted)

7 MOTOR TRUCKS
(Details Omitted)

Total Insurable: xx xx xx xx
Total Non-Insurable: xx xx xx xx

(b) An Individual Sheet

The Joyce Company
Details of Shop Equipment-July 1, 1930 (Production Machinery)

<table>
<thead>
<tr>
<th>Dept. FMB5</th>
<th>Building FMB</th>
<th>Thread-Rolling Machings</th>
<th>ORIGINAL Cost Allowance</th>
<th>REPRODUCTION Cost Allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1</strong> Jordan Thread-Rolling Machining</td>
<td>xx xx</td>
<td>xx xx</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Complete description including invoice price, freight, cartage, installation, etc. cost, and depreciation rate have been omitted)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>3</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
637. Sound Value vs. Reproduction New Value and Allowance.--

When an appraisal has been accepted for entry upon the financial records, the reproduction new values and the accrued depreciation to date on this basis should be set up, both in the general ledger and in the detail property ledger, in preference to merely recording the sound values. For, if the latter figures are extended upon the face of the accounts, the auditor will have to ascertain the remaining life of each asset, since these figures are not likely to be given in the appraisal report. This takes, of course, distinctly one for an appraisal engineer; the auditor should never undertake it himself. On the other hand, if the reproduction new values and the related reserves are used, the auditor is entitled to proceed on the basis that the use of standard depreciation rates, modified to fit local conditions, will build up the reserve given by the appraisal company to the net cost of the asset by the time it is retired.

As to the method of setting forth the appraisal upon the balance sheet, the writer favors showing the gross assets (followed in parenthesis by at least the words—Appraised Value) less their valuation reserves. In his opinion these figures give the reader of the balance sheet a far better picture of the size of the plant properties than when only the sound value at the appraisal date, plus the subsequent additions and depreciation, are given.

638. Depreciation on Appreciation 1—A second depreciation problem, which arises when appraisal values are entered on the books of account, centers on the choice of a base upon which to calculate the future depreciation charge to operations. In the opinion of some accountants, the charge should still be figured on cost. When this view is held, the appraisal surplus is charged and the allowance for depreciation credited for an amount which equals the depreciation of the appreciation. Thus in the illustration above, the entry is:

Appraisal Surplus 2400.00
Allowance for Depreciation—Machinery 2400.00

To transfer the expired portion of the former account to the latter account, computed as follows:

Depreciation on appraisal values $10400.00
$(208000.00 x .05 = $10400.00)
Depreciation on cost values 8000.00
(160000.00 x .05 = $8000.00)
Expired portion of appraisal surplus $2400.00

The above transfer will be made for an equal amount during the next nine years, assuming for clearness of illustration that no new purchases are made and that the machinery is worn out exactly at the end of 20 years. Hence, during these ten years a total of $24000.00 will have been transferred from the appraisal surplus to the allowance for depreciation, and the balances in these two accounts will then be $150.00 and $207,350.00 respectively.

<table>
<thead>
<tr>
<th>Items</th>
<th>Appraisal Surplus</th>
<th>Allowance for Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Balance</td>
<td>$24150.00</td>
<td>$103250.00</td>
</tr>
<tr>
<td>Transfers 10 x $2400.00</td>
<td>$24000.00 (red)</td>
<td>$24000.00</td>
</tr>
<tr>
<td>Depreciation 10 x ($160000 cost x .05)</td>
<td>$150.00</td>
<td>$207350.00</td>
</tr>
</tbody>
</table>

1. See question 51.
At this time $150,000 worth (cost $195,000) of machinery must be eliminated from the accounts, as it has been assumed to be completely worn out. Therefore, the transfer for the next year is only $150.00. This amount represents the depreciation of the appreciation on the $10,000 (cost) machine which was bought (and erroneously expensed) one year after the others.

Appraisal Surplus
Allowance for Depreciation-Machinery 150.00 150.00

To transfer the expired portion of the former account to the latter account, computed as follows:

Depreciation on appraisal values $650.00
($13000 x .05 = $650)
Depreciation on cost values $500.00
($10000 x .05 = $500)
Expired portion of appraisal surplus $150.00

RECAPITULATION

<table>
<thead>
<tr>
<th>Items</th>
<th>Appraisal Surplus</th>
<th>Allowance for Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at end of 20 years (from above)</td>
<td>$150.00</td>
<td>$207,350.00</td>
</tr>
<tr>
<td>Machinery retired (fully depreciated)</td>
<td></td>
<td>$195,000.00</td>
</tr>
<tr>
<td>Net</td>
<td>$150.00</td>
<td>$12,350.00</td>
</tr>
<tr>
<td>Depreciation $10000 (cost) x .05</td>
<td>150.00 (red)</td>
<td>150.00</td>
</tr>
<tr>
<td>Transfer</td>
<td>0</td>
<td>$13,000.00</td>
</tr>
<tr>
<td>Balance</td>
<td>0</td>
<td>13,000.00</td>
</tr>
<tr>
<td>Machinery retired (fully depreciated)</td>
<td></td>
<td>13,000.00</td>
</tr>
<tr>
<td>Balance</td>
<td></td>
<td>0</td>
</tr>
</tbody>
</table>

Although the foregoing procedure has many adherents, the decided weight of opinion (and that of the writer) is that the future depreciation charges should be based on the new appraisal values. In fact, Montgomery says that "the auditor has no option in this matter and must insist on depreciating book values or he must qualify his certificate." When this latter program is followed, the annual depreciation charge in the case cited is $10400.00 for the next 10 years after the appraisal, and $50.00 for the final year.

<table>
<thead>
<tr>
<th>Items</th>
<th>Allowance for Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Balance</td>
<td>$103350.00</td>
</tr>
<tr>
<td>Depreciation 10x ($208000 x .05 = $10400)</td>
<td>104000.00</td>
</tr>
<tr>
<td>Total</td>
<td>$207350.00</td>
</tr>
<tr>
<td>Machinery retired (fully depreciated)</td>
<td>$195000.00</td>
</tr>
<tr>
<td>Net</td>
<td>$12350.00</td>
</tr>
<tr>
<td>Depreciation $13000 x .05</td>
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<tr>
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<td>Machinery retired (fully depreciated)</td>
<td>13000.00</td>
</tr>
<tr>
<td>Balance</td>
<td>0</td>
</tr>
</tbody>
</table>

During this eleven year period, the balance of the appraisal surplus account is gradually reduced to naught by transfers to earned surplus, the amounts

being exactly the same as before; namely, $2,400 for the first 10 years and $150.00 for the last year. Of course, if desired the transfers from appraisal surplus can be set up in a special profit and loss account such as, Depreciation of Appreciation. In either instance, it is advisable to set up from Earned Surplus a like amount ($2,400-$150) in an appropriated reserve. However, this is optional except when securities have been issued against, or represented and sold on the basis of the appraised values; and similar situations.

In comparing these two depreciation procedures, the reader should observe that in the case of trading concerns and the like, the final surplus profits are identical. But when a manufacturing plant is "involved," each method results in a different net profit, except when the inventories are valued independently of the cost records. For example, under the first plan (depreciation based on true cost) the rate of manufacturing overhead is lower because the depreciation charge is lower. As this rate is a factor in costing the final finished and in-process inventories, the net profits are necessarily less. In brief, the contention that the second method gives the more conservative results because it charges more into the cost of manufacturing operations is deceptive. It obviously results in higher inventory valuations and hence must give more surplus profits unless it is eliminated.

CONTRA CASE

"Logically, the same two principles developed in respect to write-ups are also applicable to write-downs, and they could be restated as follows: (1) devaluation initially is not loss, but capital decrement, (2) the capital decrement becomes "realized" only as the assets written down are depreciated or otherwise disposed of. If these two principles were carried into a technique of accounting for write-downs corresponding to that used for write-ups, they would call for the following procedure. First, asset values would be revised downward to conform to the appraised replacement values, and the amount of the write-down would be charged to a contra account to capital stock and capital surplus. Thereafter, depreciation charges would be based on the appraised lower values rather than on cost. This would result in the inclusion in net income of amounts corresponding to the difference between depreciation charges based on cost and depreciation charges based on appraised lower values. According to the replacement-cost theory this amount represents part of the true income available for distribution, since it is no longer needed to maintain physical capital. According to conceptions of income and capital adhered to by accountants, however, it is not income, and, if distributed, ranks as a liquidating dividend. This is clear when the next step corresponding to the appreciation technique is considered. As regards appreciation, it will be remembered, the transfer of the realized portion of appreciation surplus to earned surplus had the effect of making up for the income excluded from the net-income figure. A similar transfer to surplus of the realized portion

1. Here a credit account, and often placed under the main caption of NON-OPERATING INCOME. However, Mr. W.A. Staub believes that "if it be argued that appraised value represents capital now actually employed in the business, and that operating cost should be charged with depreciation, based on such values, then it is illogical to make periodic transfers from revaluation surplus to earned surplus; such transfers should rather be made to a replacement reserve."
of the write-down, would have the effect of cancelling the really fictitious income included in the net-income figure added to surplus. If liquidating dividends were to be paid accordingly, they would have to be the subject of a special capital distribution.

"To sum up, the results of write-downs of assets and the subsequent basing of depreciation charges thereon will be as follows, assuming that the present method of treatment is not altered: (1) an initial decrease in total assets and total proprietorship as shown on the balance sheet, (2) an overstatement of actual income throughout a subsequent period in so far as assets subject to amortization, depletion, and depreciation have been the object of revaluation. The net effect of writing depreciable assets down to replacement values, and subsequently basing depreciation charges thereon, is to transfer piecemeal to surplus as net income the amount of the write-down. The nature of the account to which the write-down was originally charged will thus determine the nature of this portion of "earned surplus" and the true character of cash dividends based thereon. If the write-down was charged to earned surplus, the amount is simply restored thereto. If the write-down was charged to paid-in surplus or to a surplus arising from legal reduction of capital, the amount represents a portion of contributed capital. Consequently, to the extent that it becomes the basis of cash-dividend declarations, liquidating dividends are in effect being paid. Legally, this may not be the case, since paid-in surplus is often available for dividend purposes.

"In conclusion, it can be said that the effects of present write-downs will probably be more in keeping with the replacement-cost theory of asset valuation than were the effects of the write-ups of the immediate past, since reduction of dollar capital will become in a way automatic. On the other hand, if original capital investment in dollars is liquidated, the stockholders should be apprised of the fact. The danger of the write-down movement lies here. The legal reduction of capital or the charge to paid-in surplus at the time of the write-down takes care of the angle of protection of creditors. But this does not reveal the fact that reported net income will subsequently be inflated during the time the assets re-valued remain undepreciated, and still more important that dividends based on such income will to some extent be capital distributions. Public accountants should insist that these facts be disclosed. Assuming that write-downs continue, as at present, to be charged off immediately against proprietorship, the disclosure to stockholders might take the following form: (1) notice on the balance sheet beside the plant item concerning the date and fact of the appraisal, (2) statement on the income sheet of the amount of net income based on cost, (3) earmarking of surplus representing that part passed thereto in excess of income based on cost valuation of assets, (4) charging cash dividends first to earned surplus based on cost, (5) notification to stockholders of the source of any cash dividends based on the earmarked surplus.

Legal reductions of capital as a means of providing surplus against which write-downs can be charged may possibly be approved on the theory that corporations could easily achieve the same result by going through a reorganization. But at least the stockholders should know what is going on, not only at the time of the write-down, but in subsequent years when it has its effect on income and surplus."1

639. Revision of Rates.—Too much emphasis can scarcely be laid upon the necessity of comparing the actual performance of an asset with its expected usefulness. At the outset the rate which is selected for it is at most but a rough estimate of the actual service life of this particular asset, for it is "merely a forecast based upon a study of its ancestors."

Moreover, "there has grown up a rather slavish adherence to a principle that depreciation is "gradual" and therefore "constant"; that is, if 10 per cent is once taken, 10 per cent must be continued until salvage value is reached. In many instances this is not sound. It is proper to adopt a consistent plan and to adhere to it until actual conditions call for a change. If it is calculated that machinery depreciates by a given percentage under certain conditions, it is consistent to change the percentage when the conditions change."

"On the other hand, modifications of rates must not be abused although opportunities and temptations may be plentiful. There may be a wide difference of opinion as to the amount of the allowance to be made at any time on any asset. Many company officers prefer to regard depreciation charges as flexible, and arbitrarily adjust them in different years so that in time of large profits the allowance may be large, and during unprofitable years the allowance small, or none. Others consider the rates inflexible, and never vary them.

"Either procedure, however, is opposed to sound accounting principles. It is important that there should be some fixity with regard to the rate of depreciation allowed, and deviation should be permitted to the extent of an actual increase or decrease of the wear and tear, etc."  

As to the frequency with which the rates should be tested, assuming a constant load from year to year, nothing more definite than general suggestions can be offered, for local conditions are always the controlling factor. Naturally, long-lived assets require less attention than do short lived ones, and periods of feverish activity call for more frequent testing than do normal ones. In any case, however, sufficient time should be allowed to pass by before making the test to make certain that the observations which are made will be valid. (See City Ice and Fuel Co., in Poor's "Industrials" (1931) for a clearcut use of different rates).

640. Amortization of Plant.—As stated in section 624, time may be the effective cause of depreciation. Thus in many instances a hotel, theatre, department store, or other building is erected on leased land. This is a common practice in large cities, where a lease of from 75 to 99 years is erroneously regarded as the equivalent of a freehold. Furthermore, as the value of a downtown lease has often increased more rapidly than the building has depreciated, it has sometimes been difficult to get clients to admit that the building is diminishing in value because of wear and tear and/or the efflux of time. This struggle to "put across" the idea of the necessity of taking depreciation on the basis of the life of the lease, irrespective of the factor of appreciation, has sometimes been further complicated because the client was positive that he was going to renew the lease at the date of its expiration. Although intention does have a decided bearing upon the accounting treatment given certain facts or transactions, it should not be allowed to influence the amortization of longer lived property erected on land held under a leasehold. The auditor should at least require the client

1. Montgomery, p. 678.
to take a renewal option, both as tangible evidence that the client "means business", and as proof that the lease can in fact be renewed and at terms within the command of the client.

It is sometimes stated that since a building is not likely to be erected on leased land unless the term of the lease is considerably longer than the useful life of the structure, depreciation of the building should be taken on the basis of its normal useful life, in total disregard of the term of the lease.

In most cases this contention is true, but in many instances the reasoning is unsound, for it assumes that the first building will be abandoned at the end of its estimated useful life and that a new building of less substantial construction will be erected in its place to finish out the unexpired term of the lease. Some such program as this is common place in the case of frame structures, but hardly for substantial office buildings of the sky-scaper type. When a brick and steel fire-proof building is said to have a probable useful life of 50 years, it is never intended to convey the impression that the structure will actually be in ruins by that time, but that it would probably be uninhabitable if only normal repairs were made. On the contrary, therefore, the life of this building is very likely to be renewed from time to time through extraordinary repairs, or by renewals or alterations, so that the actual date on which the structure is torn down might well be 75 to 100 years after the original cornerstone was laid.

Thus, for example, if a lease runs for 60 years and a 50 year office building is erected, the allowance at 2% per annum will lack 40% (theoretical computation)\(^1\) of taking care of the total cost by the termination of the lease. Of course, certain repairs and renewals would be made of less enduring materials than those in the "original building" because of the forthcoming termination of the lease, and hence the actual deficiency of the allowance would be MUCH less than the theoretical estimate just given. On the other hand, certain repairs and renewals will have to be of the same quality as those replaced in order to comply with the local building safety ordinances, or to meet the provisions in leases taken out by present tenants, or to attract new tenants to vacant offices, or to set the renewal of present tenants whose leases run out considerably in advance of the termination of the main lease. In short, there are many factors which will prevent the client from allowing the building to go to rack and ruin.

The same sort of condition arises in the case of mining projects where replacements and betterments have to be made after the enterprise has gotten well under way, even though it is clear that their useful life will greatly exceed that of the mine. Thus, "usually after one-third or one-half the life of the mine has elapsed, and from time to time thereafter, additions to power plant and major items of equipment will be necessary, and the cost thereof should be set up in appropriate Additions and Betterments Accounts, and for these will have to be established an additional and separate depreciation rate based on the remaining coal or life of the mine."\(^2\)

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1. Theoretically, the "second" building (actually the old one largely replaced and revamped by extraordinary repairs and replacements) will only be 30 years old at the end of the 50 year lease, hence only 60% of the total cost will have been depreciated on the basis of 2% per annum. The theoretically correct rate is 2\(\frac{1}{2}\)% per annum, i.e. 200% divided by 80, the "excess" depreciation being credited to a suitably named liability account. As indicated in the text in the comments on mining projects, the replacements could be set up in a separate account and depreciated at a separate depreciation rate over the remaining life of the building.

Another important contingent cause of depreciation is the diminution in the supply of raw materials, as in the case of forests, quarries, mines, oil or gas wells, etc. In such instances the auditor must ascertain if the rate of depreciation applied to the long lived depreciable production property, which has little residual value after the depletion assets are worked out, is sufficient to reduce the cost (or other value) to the net salvage of these assets.

There are two common methods of procedure for handling this type of situation. Under one plan the net cost of the long lived production assets is written off in equal amounts over the life of the wasting asset project. Under the other program, the net cost is charged to operations on the basis of the ratio of the quantity of raw material extracted during the period to the total estimated units originally in the natural resource. The proper choice of one of the two methods is often important, and should, therefore, be selected to suit the particulars of the project under audit. Thus, if production is irregular from year to year, the second method should ordinarily be adopted.

641. Depreciation Provision vs Sinking Fund Provision.--As a rule, industrial bonds require that a sufficient sum be set aside "out of earnings" to retire the issue serially or in a lump sum at maturity. When such is the provision of a trust indenture, there is often the mistaken idea (from the writer's point of view) that no charge to income for the sinking fund installment (i.e., the creation of a sinking fund reserve out of net profits) needs to be made as the depreciation charge has already taken care of the situation. Thus Bell states the case as follows: "Many sinking fund clauses in mortgages stipulate, evidently for the better security of the bondholders, that the sinking fund installments must be paid "out of earnings"; and this is often construed as effecting a reduction of the earnings to which the stockholders are entitled. This interpretation is illogical and should be overridden if practicable. Bonds are invariably issued to pay for permanent capital assets. It being assumed that due provision is made for depreciation or depletion of the property during the life of the bonds, there should not be a double charge against income to pay for the property, that is, to keep the capital intact. There should only be a segregation of assets sufficient to liquidate the obligation at maturity. If, notwithstanding, the fallacy of so doing, amounts equivalent to the payments into the sinking fund are charged against current income, they should be credited to an Appropriated Surplus account, as such is the provision of mortgage indentures to the effect that sinking fund payments must be made 'out of earnings'."

"The accomplishment of the purpose for which sinking or redemption fund reserves are created requires primarily the setting aside of a definite fund out of the assets, this fund eventually to be utilized for the retirement of the securities. There is a prevalent notion to the effect that charges must be made against income, and a reserve created, equal to the amounts set aside in the fund. This notion is fostered by the common provision in mortgage indentures to the effect that sinking fund payments must be made 'out of earnings'."

"It may be stated generally that such a provision need be taken to mean no more than that the cash necessary to make the sinking fund payments must be derived from the operations and not borrowed. There

1. Accountants' Reports, p. 55
2. Auditing, p. 298.
are cases, however, where it is undoubtedly the intention that the income available for dividends shall be reduced by the amount of the sinking fund requirements until they have all been met. As a matter of fact there may be no essential difference in the practical application of these two requirements. The intent of both may be to restrict the payment of dividends so that the cash needed for the retirement of the securities will not be paid to the stockholders.

"This purpose is accomplished if dividends are paid only when cash derived from the operations is available, after making the sinking fund payments, and a surplus is allowed to accumulate. It is not accomplished, and the provision is violated in principle, at least, if the dividends are paid in excess of cash available from operations, money being borrowed for the purpose, although the sinking fund payments may literally have been made from earnings."

As the writer sees it, there is no necessary relationship between the amount of the provision for depreciation and the amount of the sinking fund installment. Therefore, the bondholders could not have meant the depreciation provision by their phraseology of "out of earnings." Moreover, there is no double (duplicate) charge against income. The charge for depreciation is an expense. It must be taken into consideration before the earnings are determined, where-as the sinking fund reserve charge is a segregation or reservation of earnings for a specific purpose after they are determined. Likewise, the inclusion of depreciation as a cost of operations is a necessity without any compelling bond provision, whereas the creation of a sinking fund reserve would not ordinarily be undertaken without this adverse (to the stockholders) stipulation. That is, to say that the term "out of earnings" refers to the depreciation provision is to state that the bondholders are verbosely in requiring something which MUST BE DONE anyway. On the other hand, if these words relate to the creation of a sinking fund reserve, they are full of teeth and potency. From a legal aspect, therefore, which would be the controlling point of view in a suit on the point, the latter interpretation prevails, for, when the meaning of a provision in a contract is doubtful, it is customary for equity to select the one which gives additional content to the contract and which "favors" the party for whose protection the contract was undoubtedly intended.

The creation of a sinking fund reserve, in addition to the fund itself, tends to secure for the bondholders at least two very important advantages. First, if this provision is not written into the bond indenture, the accumulation of the sinking fund might be such a drain upon the company's cash position as to imperil its solvency. The addition of a provision for the creation of a reserve "Out of Earnings," however, immeasurably TENDS to "sweeten" the cash position and thereby the current ratio, by denying the stockholders this amount of cash dividends. That is,

1. The writer realizes that his ideas at this point are undoubtedly contrary to the decided weight of opinion; therefore, in an actual situation where a client has adopted the general viewpoint, he would not call the bondholders' attention to this second interpretation of the provisions of the deed of trust but only insist on the facts being clearly displayed in the accounts, leaving it to the bond trustee and the bondholders to object to the procedure if they so desire. On the other hand, if the writer was being employed by the bondholders, he would most assuredly develop his opinion in the audit report.
the claim of the reserve to a "slice" of the current profits to the extent of the sinking fund installment takes precedence over the pressure of the stockholders for dividends. Moreover, it should be kept in mind that the surplus accumulated prior to the issuance of the bonds is morally, if not legally, unavailable for dividends, for otherwise the requirements that the sinking fund installments shall be paid "out of earnings" is often futile.

Secondly, the reserve provision builds up additional general security in back of the bonds, and of course equally for all other creditors, by enlarging the size of the networth (i.e. the capital stock, surplus, and the allowance for sinking fund) which is not subject to reduction.

642. Depreciation During Construction.—During the course of the construction of a building, for example, some physical depreciation from wear and tear of the workmen and/or from the elements must necessarily take place. The question naturally arises, therefore, as to how this depreciation should be recorded. As sound accounting theory requires that all costs of construction be capitalized until operations begin, the net result of taking depreciation on the unfinished project would be a debit and credit to the building account. In brief, both common sense and recognized accounting procedure dictate that the depreciation which is necessarily incident to the construction of an asset should be ignored. Hence for all practical purposes depreciation starts with the beginning of the useful life of an asset, which is the time during which an asset may be used for the purpose for which it was acquired.

On the other hand, consider the case of large skyscraper office buildings where it is customary for the floors to be leased just as soon as they are ready for occupancy, which for the lower floors is many months prior to the final completion of the structure. In such instances depreciation must be taken in proportion to the amount of occupancy.

In other instances, when all plant additions are authorized by a special committee, each construction account will be left open until all of the units to be erected under its particular authorization number are completed. This will be true even when the individual units are put to use as soon as they are finished. Therefore, when such is the case, it is clear that depreciation must be taken "as of an average date", or on any other reasonable basis of completion.

643. Appreciation from Physical Changes.—It is customary, as we have seen, to consider appreciation as due solely to a rise in market values, but it is equally true that it may be due to improved physical condition or adaptation. The first is found, for example, in connection with the settling and compacting of railroad beds and the solidification and grassing of slopes. These betterments go on to some degree without any further expenditure of labor or materials beyond what is reasonably chargeable to repairs and maintenance. Thus the grass on the slopes will grow thicker and the sod firmer with little or no encouragement, and the new road bed will gradually become seasoned and compact. This change will assuredly call for additional bed material, but this is a capital addition which is something quite apart from the natural increase in value of the road bed due to its gradual seasoning. Likewise, machinery which has been broken in for several months is undoubtedly more serviceable

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1. As to the corporation, the reserve provision means that it must retire the bond liability out of earnings, NOT by a refunding issue.
and efficient than it was when brand new. A certain adaptation and
wearing-in has taken place which actually makes the machine more valuable.
However true this may all be, it is not proper to bring the
increased value upon the books of account, for by common understanding all
the fruits of an expenditure belong to it and are expected to be derived
from it. Thus, if it costs $50 to seed a certain lawn, the owner will be
weighing in his mind the final picture of a well seasoned lawn resulting
from the natural growth of the grass within the next two or three years
hence, against the present cost. That is, the $50 is, after all, a measure
of the value of the lawn in its most flourishing condition some few years
hence, and not a measure of its value at the end of the first summer.
A decided exception to the above statement is exemplified in the
sale of forests where the property undoubtedly becomes more valuable from
tyre to year as the timber grows. In these cases independent appraisal
values may properly be set up in the books of account.

644. Depreciation Funds.—In this section occasion is taken to
emphasize the general impracticability of establishing a depreciation
fund, at least one to the amount of the depreciation allowances. As a rule,
the money can be much more profitably invested in extending the plant
facilities, or where this is not desirable, in paying off fixed or current
indebtedness, etc. In other instances, such as single terminating projects,
the surplus money should be given to the stockholders as a partial return
of their original investment.

645. Replacement of Parts.—When the life of an asset is given
as 20 years, it should be evident that some of its parts may have a life of
only 5 years, whereas other parts may have a life of as much as 30 years.
Thus by means of renewals and replacements it is possible to give new
life to an asset beyond its original life period. However, it must also
be clearly understood that this sort of thing can not go on forever.
Every product of man must eventually heed the call of the grim reaper.
In the case of a major, i.e. extraordinary, repair that extends
the life of an asset, it is feasible to charge the cost in full to the
allowance if the worn out part was about as expensive as the replacement.
On the other hand, if the cost of the new part is undoubtedly considerably
different than that of the worn out part, the theoretically proper method of
handling replacements should be followed; namely, (a) charge the allowance
with the estimated cost of the old part (if its exact cost is unknown) and
credit the asset; and (b) charge the asset with the cost of the new part.
In this connection the factor of coterminous life must sometimes
be taken into consideration lest a new attachment or a replacement be
depreciated at its normal rate instead of on the basis of the remaining
life of the asset as a whole. Thus if a 20 year "non-transferable"
attachment is added to an asset having a maximum remaining life of 15 years,
considering all possible prolongments of original life via renewals or parts,
the whole cost of it must be written off within the next 15 years.

646. The Adequacy of an Allowance.—It is sometimes stated that
a comparison of the depreciation allowances on the successive balance sheets
of a concern will reveal to the inquirer whether or not sufficient depresca-
tion is being taken. Unfortunately there is no foundation for the assertion.
For example, if an allowance for depreciation stays at the same level or
with but slight increase, it is not a fair inference to deduce that little
### A SUMMARY OF PROPERTY AND DEPRECIATION SCHEDULES PLATE 194

The Hesseltine Bleachery, Finishing, and Print Works

Summary of Property and Depreciation Schedules

2-8-31

(LEFT SIDE) B/S Audit for the Year Ended December 31, 1930

<table>
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<tr>
<th>Analysis</th>
<th>Plant Property Schedule</th>
<th>Our Report</th>
<th>Additions</th>
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<td>Production Machinery</td>
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<tr>
<td>Hand Tools</td>
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<tr>
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<td>Factory Motor Vehicles</td>
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<td>Water Rights &amp; Franchises</td>
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<td>Restaurant Equipment</td>
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| Totals | |

**OMISSIONS**

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647. Explanation and Comments.— This grand summary schedule is prepared from summary schedules M-1 to 16, and KK-1 to 13. These schedules in turn are supported in most instances by subschedules. Thus M-4 is detailed in M4-a and M4-b which give the additions and retirements respectively.

Mr. F.W.Kilduff has prepared the following classifications of plant properties (Auditing and Accounting Handbook, p.262.).

**CONDENSED STATEMENT FOR BALANCE SHEET PURPOSES**

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<thead>
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<th>Group A</th>
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<tr>
<td>1. Land and Land Improvements</td>
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<tr>
<td>3. Machinery and Equipment</td>
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<tr>
<td>5. Furniture and Office Appliances</td>
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<tr>
<td>7. Sundry Equipment</td>
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Analysis - - - - - Allowance for Depreciation - - - -

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<th>Our Report 1930</th>
<th>1930 Provision Charges</th>
<th>Balance</th>
<th>Sound Value</th>
<th>Sound Value</th>
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<td>12/31/29</td>
<td>12/31/30</td>
<td>12/31/29</td>
<td>12/31/30</td>
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</tr>
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</table>

(continuation of the explanation and comments)

For General Ledger Classification Purposes

Group B

KK-1

1. Land, Industrial

2. Land, Non-industrial

KK-2

3. Land Improvements and Appurtenance

4. Outside Piping, Wiring, and Accessories

5. Buildings, Fireproof

6. Buildings, Non-fireproof

7. Building Equipment

8. Building Equipment

9. Machinery

10. Electric Machinery and Apparatus

11. Power Plant Machinery and Equipment

12. Ovens, Furnaces, Forges, and Kettles

13. Power Transmission Machinery and Equipment

14. Conveying, Loading, and Hoisting Equipment

15. Semi-durable Tools and Apparatus

16. Fixtures, Jigs, Dies, Punches, and Other Special Production Equipment

17. Fire and Police Equipment

18. Railroad Equipment

19. Sundry Fixed Factory Equipment

20. Sundry Portable Factory Equipment

21. Factory Trucks, Tractors, Carts

22. Material-weighing and Measuring Equipment

23. Welfare Equipment

24. Sundry Electric Wiring Systems

25. Sundry Piping Systems

26. Patterns and Drawings

27. Office Furniture

28. Office Machines

29. Sundry Office Equipment

30. Factory Furniture

31. Transportation Equipment, Motor

32. Transportation Equipment, Electric

33. Transportation Equipment, Horse

34. Transportation Equipment, Sundry

35. Miscellaneous

KK-11

KK-12

KK-13

Totals

For Property Ledger Classification Purposes

Divisional Classifications

Group C

Land and Land Improvements

1. Land, Industrial

2. Outside Wiring and Lighting Equipment

3. Drainage Piping and Auxiliaries-Yard

4. Water Piping and Auxiliaries-Yard

5. Outside Appurtenances, Structural

6. Outside Improvements and Appurtenances, Non-structural

7. Land, Non-industrial (Improved)

8. Land, Non-industrial (Unimproved)

(Items 9 to 241 omitted)
### A Schedule on Allowances for Depreciation (1st type) Plate 195

**The Davenport Silk Co.**

Allowances for Depreciation

B/S Audit for Year Ended May 31, 1929

#### (Left Side)

<table>
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<tr>
<th>Schedule MM</th>
<th>Depreciation Allowance Per Our Papers 5-31-28</th>
</tr>
</thead>
</table>

#### Buildings

| 5-31-28 Opening asset balance | 427,543.19 @ .015 | 6413.15 |
| Net additions                  | 2342.07 @ .0075   | 17.57 |
| 5-31-29 Final balance          | 429,885.26        | 6430.72 |
| Already provided 12 mo. @ $535 |                             | 6420.00 |

**Difference** 10.72

#### Building Equipment and Fixtures

<table>
<thead>
<tr>
<th>Asset deductions $692.75 (cost) x .05 x 19 yr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>5-31-28 Opening asset balance $103,424.82 @ .05</td>
</tr>
<tr>
<td>Net additions (587.19) @ .025</td>
</tr>
<tr>
<td>5-31-29 Final balance $9755.29</td>
</tr>
<tr>
<td>Already provided 12 mo. @ $43</td>
</tr>
</tbody>
</table>

**Excess** (13.56) 4178.89

#### Omissions

Grand Total 487,629.71

### Audit Procedure

All computations were checked as indicated above.

Depreciation is taken at full rate on the opening balance plus 1/2 rate on the net additions during the period.

We found that depreciation on the delivery equipment had been entirely overlooked.

"643. Explanation and Comments." The twelve monthly depreciation charges of equal amount indicate that monthly profit and loss statements are prepared by this business.

Notice that the books were not closed when the auditors arrived, for otherwise the depreciation adjustment would have been via the Surplus account."
### RIGHT SIDE OF PLATE 195

<table>
<thead>
<tr>
<th>Debits per Books 1928-29</th>
<th>Adjustment</th>
<th>Credits per Books 1928-29</th>
<th>Adjustment</th>
<th>Adjusted Balance 5-31-29</th>
</tr>
</thead>
<tbody>
<tr>
<td>6420.00</td>
<td></td>
<td>10.72</td>
<td>6420.00</td>
<td>10.72</td>
</tr>
<tr>
<td>658.11</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>516.00</td>
<td>13.56</td>
<td>516.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>658.11</td>
<td>13.56</td>
<td>516.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>15871.53</strong></td>
<td><strong>189.95</strong></td>
<td><strong>149337.21</strong></td>
<td><strong>863.29</strong></td>
<td><strong>621768.73</strong></td>
</tr>
</tbody>
</table>

**To B/S**

### ADJUSTMENT #45

**Allowance for depreciation - Building Equipment & Fixtures** 13.56  
Machinery & Equipment 149.87  
Office Furniture 26.52  
Buildings 10.72  
Delivery Equipment 852.57

**Depreciation Expense - Building Equipment & Fixtures** 13.56  
Machinery & Equipment 149.87  
Office Furniture 26.52  
Buildings 10.72  
Delivery Equipment 852.57  

**1053.24 1053.24**
The Bretske Manufacturing Company
Allowances for Depreciation
B/S Audit for Year Ending Dec. 31, 1930

<table>
<thead>
<tr>
<th>Credits to Reserve</th>
<th>Jan.</th>
<th>2268.77</th>
<th>295.45</th>
<th>1613.31</th>
<th>321.00</th>
<th>39.01</th>
</tr>
</thead>
<tbody>
<tr>
<td>Feb</td>
<td>2268.77</td>
<td>295.45</td>
<td>1613.31</td>
<td>321.00</td>
<td>39.01</td>
<td></td>
</tr>
<tr>
<td>Mar</td>
<td>2286.46</td>
<td>295.45</td>
<td>1633.00</td>
<td>321.00</td>
<td>39.01</td>
<td></td>
</tr>
</tbody>
</table>

**Omissions**

<table>
<thead>
<tr>
<th></th>
<th>Nov</th>
<th>2551.71</th>
<th>326.37</th>
<th>1695.33</th>
<th>491.00</th>
<th>39.01</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec</td>
<td>2593.77</td>
<td>326.37</td>
<td>1695.33</td>
<td>534.00</td>
<td>36.07</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>28335.25</td>
<td>3611.79</td>
<td>19681.28</td>
<td>4575.00</td>
<td>467.18</td>
<td></td>
</tr>
<tr>
<td>Bal. per our papers 1/1/</td>
<td>245196.47</td>
<td>51689.42</td>
<td>186348.91</td>
<td>5469.69</td>
<td>1688.45</td>
<td></td>
</tr>
<tr>
<td>Grand Total</td>
<td>273531.72</td>
<td>55301.21</td>
<td>206030.19</td>
<td>10044.69</td>
<td>2155.63</td>
<td></td>
</tr>
</tbody>
</table>

**CHARGES**

Jan. New Roof Vo. #34

Same material as old

one Dept. F

Cost 8614.83

Scrap 8614.83

July JV#34 Dept. Bl-K
2 B.F. Lathes

Cost 1853.49

Net 1803.49

Removal Exp. 10.15

Charges to Res. 1813.64

Nov. 1 Rem. Typewriter

Dept F2-G JV#234

cost 130.00

acct' rec. 15.00

charge to res. 115.00

Total Charges 10543.47

Balance 12-31-30 262988.25

The above computations were made independently by us. They agree with the G/L figures. The monthly provisions are figured upon the opening balance for the month. The cost of an asset plus removal expense minus scrap value is charged in full to the reserve when it is retired as these elements were taken into consideration in setting the depreciation rates.

This is not merely a transcript of the allowance account. All figures were checked or tested or scrutinized.

In this instance the client kept but one depreciation account for the four types of depreciable assets. It was necessary, therefore, for the auditor to keep the figures separate in his own working papers.
A PROPERTY LEDGER CARD  PLATE 197

<table>
<thead>
<tr>
<th>Construction</th>
<th>SMFG</th>
<th>Floors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foundation</td>
<td></td>
<td>Roof</td>
</tr>
<tr>
<td>Walls</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Ref.</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20</td>
<td>J-19</td>
<td>Appraisal by W.H. Phillips, Inc. in file #8 section #17</td>
<td>61019.84</td>
<td>61019.84</td>
<td>0.00</td>
</tr>
</tbody>
</table>

(READER'S NOTE: This card is only 8 1/2 by 11)

OMISSIONS

RIGHT SIDE OF THE CARD

<table>
<thead>
<tr>
<th>Location</th>
<th>Erected by</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Ref.</th>
<th>Description</th>
<th>Allowance for Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20</td>
<td>J-19</td>
<td>Appraisal</td>
<td>See contra</td>
</tr>
<tr>
<td>12/31/20</td>
<td>J-35</td>
<td>1 1/2 % x 61019.84</td>
<td>15254.00</td>
</tr>
<tr>
<td>12/31/21</td>
<td>J-72</td>
<td>Ditto</td>
<td>915.29</td>
</tr>
<tr>
<td>12/31/22</td>
<td>J-101</td>
<td>Ditto</td>
<td>915.29</td>
</tr>
<tr>
<td>2/7/23</td>
<td>J-5</td>
<td>Roof replaced over Dept. DFK</td>
<td>497.83</td>
</tr>
</tbody>
</table>

OMISSIONS

650. Explanation and Comments.-- Note that the roof replacements on 2/7/23 were charged directly to the allowance instead of (a) charging the allowance account and crediting the asset account for the cost of the asset retired and (b) charging the asset account with the cost of the new replacement. The former method is satisfactory if the cost of the replacement is approximately the same as the cost of the retirement; otherwise the two steps outlined above should be followed. Thus, if a wooden roof is built to replace a worn out wooden roof, the repair costs may be charged to the allowance if the cost of each roof is about the same. But if a slate roof is built to replace a worn out wooden roof, the situation is entirely different; and the second (correct) method must be used.

Furthermore, it should be noted that the full cost of repairing the roof is chargeable to the allowance. It is incorrect to say that the portion of the allowance applicable to the roof is the cost of the roof times the depreciation rate times the life of the roof. This reasoning fails to note that the depreciation rate applied to the building as a whole is too low for certain items and too high for others. That is, for practical purposes the building cannot be divided into a multiplicity of units with different rates of depreciation; therefore, a fair average rate is selected which presumably will provide a sufficient allowance for each asset (portion of the building) as it is retired.
Balance per G/L 6/30/30

<table>
<thead>
<tr>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>435633.72</td>
</tr>
<tr>
<td>To B/S</td>
</tr>
</tbody>
</table>

Balance per our papers and per G/L 6/30/29

<table>
<thead>
<tr>
<th>To P &amp; L account representing the depreciation on the appreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>(23020.57)HH</td>
</tr>
<tr>
<td>435663.72</td>
</tr>
</tbody>
</table>

Balance as above

<table>
<thead>
<tr>
<th>Buildings - Surplus</th>
<th>Machinery - Surplus</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/30/29</td>
<td></td>
<td></td>
</tr>
<tr>
<td>279148.23</td>
<td>179536.06</td>
<td>458684.29</td>
</tr>
<tr>
<td># 4691.15 M-3</td>
<td># 18329.42 M-3</td>
<td></td>
</tr>
<tr>
<td>6/30/30</td>
<td></td>
<td></td>
</tr>
<tr>
<td>274457.08</td>
<td>161206.64</td>
<td>435663.72</td>
</tr>
</tbody>
</table>

# Represents the difference between the current year's depreciation charges on the appraisal values over that on the cost values. See depreciation schedule M-3 for the details thereof.

651. Explanation and Comments.--This schedule shows that the company figures its depreciation on the appraisal value of the assets. Moreover, it passes a credit from the Appraisal Surplus to the current Profit and Loss account in the amount of the depreciation on the appreciation (i.e. the excess of the depreciation charge on the appraisal values over the charge on cost).

For a discussion of various methods of handling depreciation on appreciation, see section 638.
or no depreciation is being charged to operations. On the contrary, it might very well be that because the original units were added to at various times the charges to the allowance for the asset retirements practically offset the increases in the allowance from current depreciation expense.

On the other hand, the normal tendency of another allowance might be to increase appreciably from year to year. This condition is obviously true of allowances related to single long-lived assets, such as buildings. However, it must be recognized that even here the cost of extraordinary repairs, which are properly chargeable to the allowance, may wholly or partially counteract the current year's increase, so that for this particular period it would appear as if the depreciation cost had been tampered with.

The third possibility is for an allowance to have a normal tendency to decrease from period to period. Of course, this is quite unusual, and being such, it should receive very careful scrutiny. Thus a battery of machines may be on the verge of very gradual obsolescence, and the management, forecasting the future correctly, has decided not to replace the machines as they wear out. In such an instance it is quite possible that the retirements might overbalance the current additions to the allowance, especially if the machines were originally added in groups but at irregular intervals.

647. See Plate 194.
648. See Plate 195.
649. See Plate 196.
650. See Plate 197.
651. See Plate 198.¹

¹ Before closing this chapter attention is called to the chapters on plant properties where additional comments and plates on depreciation are to be found.
651-a. Audit Program.

1. On a first audit verify the opening balance of the allowance account by ample testing, etc., for a number of past years. Make necessary corrections, if any. Qualify the Auditors' Certificate if not permitted to make this examination. State clearly in the Auditors' Certificate the responsibility assumed for the accuracy of the opening balance.

2. Verify all charges to the account against journal entries, vouchers, calculations, etc.

3. Check all charges that arise from sales, transfers, or other dispositions of plant, to the property schedules for evidence of the failure to charge the account with the proper amount, or at the time of each disposition, etc.

4. Ascertain what method of computing depreciation is being used, and then determine its fitness for this particular business. State the basis of depreciation in the profit and loss statement and report.

5. Verify all credits to the account against journal entries, property schedules, vouchers, calculations, etc. Make certain that no depreciable property has been overlooked.

6. Make certain that the method of taking current depreciation has not changed, without justifiable cause, from the method used in the past.

7. Ascertain if there are any instances where scrap value and/or demolition cost are large enough to be considered.

8. See that depreciation is treated as an operating cost, NOT as a reservation of profits.

9. Keep constantly in mind the ratio of the allowance account to the cost of the asset is NOT a measure of the asset's efficiency.

10. By test and scrutiny, knowledge of the size and change in the various asset accounts, respective rates of depreciation, etc., determine if the allowance accounts appear "regular." Have they increased or decreased in the account "as you" expected?

11. Ascertain if the allowance includes a provision for deferred maintenance.

12. If the plant property has been set up at appraised, or similar, value, see that the depreciation charge is computed on this value.

13. In continuation of #12, see that the proper amount is transferred from appraisal surplus to earned surplus, or better, to a special appropriated earned surplus account.

14. Do not permit current appreciation to offset current depreciation. Record each separately, if proper.

15. Ascertain for each group of assets, or individual large assets, what the EFFECTIVE cause of depreciation is.

16. Determine, in view of the above, if the depreciation rates are adequate.

17. Determine, in the case of probable functional depreciation resulting from inadequacy (supersession) or from obsolescence, if these causes are sufficiently definite for you to insist upon an allowance for it.

18. In general, do not permit the client to carry over as deferred charges any losses occasioned by property retired through inadequacy or obsolescence.
19. Determine if accidents, due to malicious acts, negligence, the elements, structural defects, etc., are sufficiently regular, common, and definite for you to insist upon an allowance for it.

20. Determine how efficient the ACTUAL repair and maintenance policy of the client is.

21. Determine if the client should provide an Allowance For Repairs and Maintenance account for the proper handling of repair costs.

22. If current repairs and maintenance charges show conclusively that there is considerable deferred maintenance (postponed purposely to effect profits, or necessitated by lack of cash, or by rush orders, etc.), provide an allowance for it.

23. In determining the adequacy of depreciation rates established on the basis of wear and tear, etc., remember that local conditions MUST be taken into consideration. Are there heavy stamping presses on the upper floors, causing excessive building vibrations? Is cheap fuel being burned in boilers under forced draft? If there piece work or hourly wages? How many shifts are there? Depreciation does not increase directly proportional to overtime.

24. Remember that some assets depreciate as much or more when idle than when used. Few idle assets should escape all charges for depreciation. Idle assets, subject to obsolescence, must take a full rate of depreciation. Consider each case separately.

25. Ascertain if depreciation is being taken on machinery held in storage. Is this procedure proper under the particular conditions present? Consider each case separately. Distinguish between replacement machinery, and obsolete (or excessive) machinery.

26. When appraisals are set up, see that the proper portion, if any, is entered in the earned surplus account.

27. Consider constantly by reviewing the actual condition of the physical assets, the changes in the client's current operations or future program, etc., the need for a revision of the rates, either currently or permanently.

28. Keep constantly in mind that obsolescence is probably more often an important factor in depreciation than is wear and tear.

29. Determine the effect of leases upon the depreciation rates.

30. Do not take depreciation during construction.

31. Appreciation from physical changes may be recorded in special instances only.

32. Discourage the client from setting up exhorbitant depreciation funds.

33. When betterments are added to an asset, determine the new length of life of the asset.

34. The writer believes that an allowance for depreciation does NOT relieve the client from literally following the instructions of a bond provision to the effect that a yearly sum be set aside "out of earnings" to retire the issue.

35. Determine from property records the age and depreciation rates of selected existing assets for the purpose of seeing if any of them have been more than written off because of excessive rates.

36. Determine the adequacy of the depreciation rates by observing the excess or insufficiency of the accumulated allowance when assets have been retired in the past.
37. Ascertain from the property records if depreciation is being taken on any retired asset.
38. Examine directors' minutes, etc., for authorization of the depreciation rates. Are they proper?
39. "-----Ask each ---- corporation to cause a statement of the methods of accounting and reporting employed by it to be formalized in sufficient detail to be a guide to its accounting depart-
ment-----; to have such a statement adopted by its board so as to be binding on its accounting officers-----"

(a) In respect of capital assets, the statement should show:
   (1) What classes of items are charged to property account (whether only new property or also replacements and im-
   provements);
   (2) Whether any charges in addition to direct cost, either for overhead expense, interest or otherwise, are made to property accounts;
   (3) Upon what classes of property, on what basis, and at what rates provision is made for, or in lieu of, depre-
ciation;
   (4) What classes of expenditures, if any, are charged against reserves for depreciation so created;
   (5) How the difference between depreciated value and realized or reclaimable value is dealt with on the sale or abandonment of units of property;
   (6) On what basis property purchased from subsidiary companies is charged to property account (whether at cost to subsidiary or otherwise). ---- A.I. of A., "Audits of Corporate Accounts," p. 15.

40. Examine carefully any extraordinary repairs charged to the allowance. Do they extend the life of the asset?
41. Examine carefully any replacements charged to the allowance. Why weren't the retired items charged to the allowance and the replacements charged to asset accounts?
42. If the depreciation rates are never changed after long periods of time, or if no adjustment of the rates for a single year is ever made, or if no assets are ever subject to obsolescence rates, it is prim. facie evidence that the client is pursuing a slip-shod depreciation policy.
43. If a composite rate is used, verify its accuracy.
44. Remember that "standard rates are useful as indices only."
45. For depreciation of small tools, patterns, dies, etc., see Chapter 27.
46. Depletion is usually best computed on an output, NOT a time basis. Appraisal values of the wasting assets are often for superior to cost values.
47. Frequent estimates of remaining usable material should be made by engineers, and the accounts must then be adjusted thereto. The most common method is to let the past depletion charges stand as already recorded, effect being given to the new estimates in future entries only. In many instances it is desirable to let the new estimates effect the past as well as the future entries.
1. Define and comment upon "the fixed percentage of diminishing value method" of depreciation.

2. Comment fully upon the necessity of revising depreciation rates.

3. Is it ordinarily advisable to establish a depreciation fund? Why?

4. What is the "accountants' viewpoint" of depreciation?

5. What is the difference between depreciation and depletion?

6. Define and comment upon "the service output method" of depreciation.

7. Should depreciation be taken on cost or on appraised sound value, assuming the latter is on the books of account? Why? How?

8. Is it correct to offset appreciation against depreciation? Why?

9. In formulating a depreciation policy why is it necessary to assume that the client is a going concern?

10. Define and comment upon "the composite life method" of depreciation.

11. Under what conditions might sufficient yearly depreciation be taken and yet the reserve remain at a practically constant level?

12. Define and comment upon "the changing percentage of cost less scrap method" of depreciation.

13. What is the proper accounting treatment of depreciation caused by accidents? Present your views in the form of a complete discussion.

14. Draw up a complete table of causes of depreciation.

15. Define and comment upon "the working hours method" of depreciation.

16. What is the "financing viewpoint" of depreciation?

17. Describe 3 different methods of handling repairs. What are the advantages and disadvantages of each.

18. Define and comment upon "the maintenance method" of depreciation.

19. What bearing has the repair and maintenance policy of a business upon depreciation?

20. What is the proper accounting treatment of depreciation caused by contingencies? Present your views in the form of a complete discussion.

21. Define and comment upon "the fifty per cent method" of depreciation.

22. When should depreciation during construction be recognized?

23. Define and comment upon "the straight line method" of depreciation.

24. Distinguish between deterioration and depreciation.

25. Define and comment upon "the replacement method" of depreciation.

26. Give a full discussion of the topic "The Effect of Local Conditions on Depreciation Rates".

27. Define and comment upon "the appraisal method" of depreciation.


29. Is there any actual physical depreciation of a building during its construction? Why isn't it recorded in the books of account?

30. Can appreciation ever be due to an advantageous physical change?

31. Explain, through an illustrative problem, how depreciation on appreciation is handled when the current provision for depreciation is based on cost.

32. When a bond indenture provides that the provision for the sinking fund is to be taken "out of earnings", how might this be construed as resulting in a double charge to income? What is your opinion of this whole problem?

33. What is doocapitio? Is it ever more effective than wear and tear? When?

34. When is time the effective cause of depreciation?

35. A client of yours maintains that the term of his lease has no bearing on the rate of depreciation to be applied to certain immovable assets which have a useful life beyond the lease because he intends to renew the lease. What position on the matter would you take?
36. Explain wherein prospectuses are misleading when they state that the net profits are available for depreciation and dividends.
37. Give a definition of depreciation other than one of those stated in this text.
38. Is the size of the depreciation allowance an inverse measure of the efficiency of the asset to which it relates? Why?
40. Under what conditions might an allowance of a long-lived asset fail to show an increase even though normal current depreciation has been credited to it?
41. Define and comment upon "the sinking fund method" of depreciation.
42. Explain, through an illustrative problem, how depreciation on appreciation is based on the appraisal values.
43. Name 10 different kinds of value.
44. Define and comment upon "the gross earnings method" of depreciation.
45. What bearing has the factor of coterminous life upon the proper rate of depreciation?
46. State the case for establishing on the books of account the appraised sound value of fixed assets in place of the depreciated cost value.
47. Define and comment upon "the annuity method" of depreciation.
48. What is the "engineers' viewpoint" of depreciation?
49. Under what conditions might an allowance decrease from period to period despite proper additions for current depreciation?
50. Do you agree with the answers to the following questions? If not, why not?

"Question."--This involves transactions between Corporation A and Corporation B, both corporations being engaged in quarrying. Corporation A is a South Carolina corporation and Corporation B is a Georgia corporation. The plant of B corporation is in South Carolina.
"Corporation A purchased the physical property of B at cost as shown by books of B, paying for those assets with capital stock, par value $100. The assets purchased were taken into the books of A at cost.
"That was a closed transaction. Tax returns have been made for the period in which this transaction took place and have been approved by the government as no profit or loss on the transaction.
"The quarry land operated originally by Corporation A is owned outright by the corporation. The plant purchased by Corporation A is situated on leased land and for this lease a royalty is paid, based on the tons quarried. The depletion on the original land of A corporation was fixed several years ago by the government at two cents per ton quarried. This was done after the government had made a survey of the property.
"Three or four months after Corporation A acquired the properties of Corporation B, Corporation A passed a resolution requiring that all the property of the corporation be appraised and the appraisal value written into the books. This appraisal increased the value of the quarry land owned originally by A and the value of the machinery at both plants. Entries were placed on the books charging land and machinery with a figure which would cause those accounts to reflect the appraisal values. This was, of course, offset by a credit to 'reserve for appreciation.' Corporation A then issued stock, par value $100, for the amount of the reserve for appreciation and put an entry on the books charging reserve for appreciation, thereby closing that account, and crediting capital stock.
"In this stock issue that portion representing the appreciation of original property was issued to original A stockholders and that portion
50. (Continuation).

Review Questions (Continuation)

representing appreciation on purchase property was issued to original B stockholders. It appears that the appreciated values were purchased by stock.

"What I wish to know is how should the property values be shown in the balance-sheet and how should the following items be presented in the profit-and-loss statements:

- Depletion on cost
- Depletion on appreciation
- Depreciation on cost
- Depreciation on appreciation

"Answer No. 1.--The case simmers down to these facts:

(1) That certain capital assets of a corporation have been appraised and the appraised values have been established on the records.

(2) That capital stock has been issued against the surplus from such appraisal.

"It follows, therefore, that in stating these capital assets in the balance-sheet there must be appended to the description a reference to the fact that these assets are stated at values appraised by blank company as at blank date. Preferably, the details of surplus accounts presented in the balance-sheet should clearly indicate the amount of surplus which arose from appreciation and its elimination by the issuance of stock. In view of the fact that there remains no surplus from appreciation against which to charge depletion of appreciation, it follows, inevitably, that depletion must be charged against operation, based upon appraised values, which will comprise the two elements of depletion of cost and depletion of appreciation. If details of profit and loss are published, the profit-and-loss account should indicate that the depletion therein included is based upon appraised values. The same principles apply to the question of depreciation.

"Answer No. 2.--As to the statement of property in the balance-sheet it is our opinion that they should be shown as being at values, 'as appraised by . . . . . . . . as of (date).'

"As to treatment of depletion and depreciation in the profit-and-loss statement, we are of the opinion that no distinction should be made between depletion and depreciation on original cost and on appreciation value, in view of the fact that capital stock has been issued for the amount of the appreciation and that therefore all the depletion and depreciation must be charged against operations."1

51. On the basis of the following arguments, what position on the matter do you take? Why? What other arguments can you advance?

Depreciation on Original Cost: 1. "The cost of production can mean only the actual cost of production. The fact that it may be impossible to replace the productive facilities at their original price has no bearing on the cost of the goods produced during the current period and can affect only the cost of goods produced in the future after the new facilities are required.

2. "An engineering appraisal is ordinarily but an estimate by the appraiser of the replacement cost at the date of the appraisal. Even if it should accurately reflect the current replacement cost, it is impossible to predict what the replacement cost will be in ten, twenty, or more years when it becomes necessary to replace the property."

51. (Continuation)

3. "Books of account (and the accounting statements prepared therefrom) are historical records. In computing depreciation the one historical fact we have is cost. When we depart from cost, we are entering the realm of conjecture and, if it be consistently attempted to base depreciation on replacement cost, the result must be widely fluctuating depreciation charges, which distort profits and comparative costs of different periods.

4. "When some companies in an industry have old plants and other companies have modern plants, the companies with the old plants should have the benefit of the lower depreciation charges to offset the increased efficiency of the modern plants. Otherwise the older plants are handicapped in competition, assuming that production costs determine selling prices.

5. "The fixing of selling prices is a function of management, and, if it be deemed advisable to recoup in the selling price the difference between the cost of productive facilities and their replacement cost, selling prices may be so fixed, but this policy has no bearing on the depreciation account. Financing the replacement of assets is a problem of management, not of accounting.

6. "Machinery and equipment are ordinarily replaced gradually and in a rising price period the depreciation based on cost will gradually increase even though depreciation is not computed on replacement values.

7. "Since such rapid progress is being made in the development of productive processes, it is practically certain that when it becomes necessary to replace a plant item it will not be replaced with an exact duplicate but with an improved type. One new machine may be installed to do the work of three machines which have been discarded. A new plant better designed may produce more than a larger plant inefficiently designed. Consequently, there is no necessary relation between the replacement cost of an existing asset and the amount which will actually be expended for its eventual replacement.

8. "Any provision which the management believes should be made for excess cost of replacements should be made by appropriating earnings in a reserve or by retaining adequate surplus. The problem is not different in principle from that arising with respect to the larger investment in inventories required in a period of rapidly rising prices. Unless new capital is introduced, profits must be retained in the business to furnish the needed working capital.

9. "Charging manufacturing costs with depreciation on appreciated values is unfair to the consumer. If the eventual replacement cost is less than the current replacement cost, the business has benefited at his expense. If it is greater, the future consumer has benefited at his expense. In any event he is insuring business against price fluctuations without any adequate considerations.

10. "If interest is not to be considered a part of manufacturing cost (and this seems to be the consensus among accountants) though it may be an influence in determining selling prices, depreciation on appreciation is not a part of such cost, though both must be considered by the management.

11. "If manufacturing costs inclusive of depreciation on appreciation are used for inventory purposes, the inventories will be overstated.

12. "In many industries selling prices are determined by forces entirely beyond the control of the individual management and there is accordingly no advantage in charging manufacturing costs with depreciation on replacement costs of plant."
51. (Continuation)

12. "Inventories are carried at cost or market whichever is lower and charged to cost of sales at such valuation, even though they have appreciated in value. Why then charge costs with appreciation in plant values? The inventories must be replaced much sooner than the plant."

Depreciation on Replacement Cost:

1. "The function of depreciation is to assist in maintaining capital, not in merely stating historical facts."

2. "Where a company has old plants and new plants it is necessary to charge manufacturing cost with depreciation on appreciation in order to have all plants on a comparable basis."

3. "In the interest of an industry as a whole, since different concerns will have acquired plants at varying costs, depreciation should be charged on a uniform basis to avoid damaging competition and permit a reasonable profit to all properly conducted businesses in the industry."

4. "Whereas the determination of selling prices is a function of management, management is entitled to all the assistance that accounting can render, and the inclusion in manufacturing costs of depreciation on appreciation is a distinct aid to management in determining sale prices."

5. "The preservation of capital is not merely a matter of preserving the dollars invested in the business. When those dollars have been used to acquire productive facilities the preservation of capital requires the preservation of these facilities. When the replacement cost of these facilities increases, in order to preserve capital this increase should be recovered in the cost of product."

6. "Even though replacement cost may subsequently decline, if a business is fortunate enough in a time of high prices to have plant facilities acquired at low prices, the business and not the customer should benefit."

7. "When prices are rising and the value of the dollar is declining, gross earnings may increase rapidly. At the same time productive facilities are being consumed which may have to be replaced with the dollars of diminished value."

If the dollars necessary to replace the facilities are not recovered through costs and segregated in a special surplus or reserve account, excessive dividends may be paid out of increased dollar earnings, part of which do not represent actual earnings if measured by the purchasing power of the dollars received.

In other words if a workman received an increase in wages and the cost of living increases correspondingly, he has no increase in real wages. Correspondingly, if a manufacturer receives increased selling prices, and the replacement cost of the facilities consumed increases correspondingly, he has no increase in real profit.

8. "Appreciation is merely an accretion in the value of an asset and should be treated in the same manner as the original cost of the asset."

---

1 W.A. Staub, The American Accountant, Jan. 1932 (p. 7)
652. Introductory Remarks. -- The chief problem of the auditor in his analysis of the various surplus accounts is to determine just how they came into being, and then, having these facts before him, he must draw up a correct descriptive picture of this portion of the net worth. Moreover, in the case of appropriated reserves, the auditor must also ascertain if they have been set up in full compliance with the authorizations of the board of directors, or the requirements of the provisions of a stock or bond issue. In other words, as soon as both the assets and the liabilities have been audited, the AMOUNT of the net worth of the business has also been automatically verified so that, to repeat, the auditors remaining duty is to unravel the history of its accumulation and disbursement through stock issues, earnings, dividends, assessments, donations, appropriations, losses, etc.

652a. Audit Program.

653. Profit in Special Cases. -- As the opportunity of reiterating certain principles bearing upon moot points offers itself once more at this time, the occasion is seized to discuss (1) profit on work-in-process (2) profit on goods awaiting delivery (3) interdepartmental profits (4) profit on sales of assets (5) profit on export sales.

(1a) When a factory undertakes production only when an order has been placed with it for these goods, as in the case of some machine shops, or when a factory has one or more orders-in-process which are already under firm sales contracts to definite customers, or when production is on a cost plus basis, the management may desire to take up the profit on the goods-in-process at the balance sheet date in proportion to the extent that they are finished. The crux of the problem is, of course, that there may never be a profit, except in the last case cited. In fact, when the final costs of the production are assembled, the outcome may be a loss. However true this may be, the practical requirements of a certain few situations demand that these

1Assuming costs to date have not exceeded expected costs. 2There is also, of course, the very difficult problem of estimating the profit properly.
possibilities of final loss be treated as POSSIBILITIES rather than as PROBABILITIES, OR the position may be taken that the loss on the contract as a whole can be reasonably assigned to definite periods in which it appears to have been incurred. It is true that the profits taken in this manner will at best be only estimates, but any complaint on this score shows that the opponent of this plan is forgetful of the fact that most financial statements are largely made up in this way.

Although the above procedure is undoubtedly theoretically correct, it is VERY RARE, however, for conservative managements to adopt it, unless its omission would be fatal to the preparation of usable comparative statements, especially the profit and loss statements. As for the balance sheet, it must be observed that its accuracy is not as greatly affected as the profit and loss statement by the omission of a certain amount of profit or loss. Thus the omission of a profit of $10,000 out of a total of $100,000 is 10%, but in relation to a total assets of $1,500,000 (upon which the profit is assumed to be earned) the error is but 2/3 of 1%.

Moreover, it should be seen that IF the overlapping of profit from year to year is about the same when the adjustments are not undertaken, the net profit for the various periods, except for the first one, is after all, but slightly in error,—and not necessarily always understated either.

(1b) In la above, both the unit of work and the number of units in process was tacitly assumed to be relatively small. It remains, therefore, to consider the problem of profits on long-term contracts where the unit of work is large, as in the case of a "sky scraper", steamship, bridge, canal, or similar project.

A little consideration of this question in its various ramifications and aspects will show that it is entirely different from those instances cited in 1a. There it was pointed out that although it is theoretically correct in some few instances to take up proportional profit on the work-in-process, nevertheless, the practice is frowned upon by conservative managements as more or less picayune window dressing. On the other hand, where long term contracts on large construction units are in force, the equitable treatment of stockholders and others requires that the total expected profit be apportioned piecemeal through the period of the construction work in proportion to the progress made and the costs incurred. Moreover, it would be rather fallacious, would it not, to show in the month when the work is completed (assuming monthly profit and loss statements for the sake of stressing the point under discussion) the profit on the whole contract when it was really earned during many months or even years?

As to the proper method for estimating the periodic profits, no rule of thumb can be offered for the novice's guidance. Each case is more or less unique calling for the use of experienced judgment rather than the application of a book formula. As the contract price is for the project as a whole, painstaking care must be exercised in estimating the additional cost to complete the undertaking, and thereby establishing a revised estimate of the final expected profit on the contract as a whole.

(2) Under ordinary conditions goods which have been completed and sold, but which are on hand and segregated awaiting delivery, may be treated as sales if the title has legally passed to the buyer. As stated in Regulations 74 article 101, "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 sales 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."

In other instances, where the goods are standard and the custom of the trade is to freely allow cancellation to take place at any time without law suits or other settlement, such as is prevalent in some lines of the clothing
industry, the profit should not be taken up until there is actual, as well as constructive, shipment of the order.

(3) It is sometimes stated that goods should not be billed from one department to another at an increase in price. In the writer's opinion, the auditor should never object to this procedure if it is what the client wants. The auditor should accept the conditions as they are, because the client finds them useful for his purposes. Too often the auditor takes the attitude that he is called upon to make a convert of his client, whereas his simple, but burdensome, duty is to make some reasonable—not necessarily minutely accurate—reduction in the final inventory for the aforesaid inflation.

(4)1 and (5)2 If shares of treasury stock are bought and sold at a small profit, or if a small profit arises on the sale of an asset, the amounts might just as well as not be included in the profit and loss statement in the non-operating income section, and thence transferred to earned surplus in the net profit figure. But if these profits are substantial, they must be entered direct into a capital surplus account. The question of their disposition as dividends depends first upon the corporation act of the state of incorporation, and second upon the cash position of the business. The first is the controlling and unalterable factor; the second, a matter of financial policy, for it is legally permissible to borrow the money wherewith to pay a dividend.

(6) In certain instances when goods are shipped to little or totally unknown foreign customers against open drafts, it is well understood by the skipper that the proposition is somewhat of a gamble. Therefore, as the drafts are apt to be dishonored, the shipments must not be credited to sales. The most liberal treatment is to include the goods in the shipper's inventory at cost plus all charges against it to date, PROVIDED the goods could be resold for at least this sum.

654. Common Changes in Surplus.—Naturally, the chief source of surplus is from net profits. Other well known items are stock assessments, excess of book value of company's own stock or bonds over purchase price, capital stock premiums, forfeiture of stock subscriptions (in certain states), donations of all kinds, excess of appraised sound value over net book value, excess of sales price of treasury securities over cost price, excess of sales price of fixed assets over book value, excess of scrap value of plant assets over net book value, and the excess of par value of one kind of security exchanged for a lesser par amount of the same or different grade of company security, or combination thereof.

On the other hand, cash and stock dividends and operating losses are the most frequent charges to surplus. So also extraordinary losses, stock discounts, excess of purchase price of company's own securities over book value, excess of net book value of a fixed asset (either investments or plant assets) over sales or scrap value, and the reduction of intangibles complete the roll call of the more usual surplus reductions.

655. Classification of Surplus.—As has been emphasized in section 652, the auditor, having ascertained the correct amount of surplus by reason of his verification of the assets, liabilities and capital stock, is mainly concerned (1) with the history of the accumulation and reduction of the sundry surplus accounts, and (2) with their proper presentation on the balance sheet. It becomes necessary, therefore, for the auditor to classify each change cited in section 654 into one of two general groups; namely, earned surplus and capital surplus. (In the writer's opinion Earned Surplus

1See Appendix C, Sec. 15-#14. 2Ibid.-#16. 3As profit arising on the retirement of a worn-out asset is probably due to incorrect depreciation, it is proper to credit it to an earned surplus account, such as Undivided Profits.
41-4

is (should be) synonymous with Profit and Loss Surplus, not with Realized Surplus.

656. See Plate 199.

657. Earned Surplus.— The contents of this account is very much in dispute; therefore, a cross section of opinions from various sources will constitute the contents of this discussion.

(1) "This account should contain all entries relative to operations and dividends. Dividends, operating adjustments, losses, etc. should not be charged to capital surplus, except in extraordinary cases, as for example when property acquired at organization is sold at a loss, nor should surplus arising from reappraisals be credited to earned surplus.

"Accretions to capital from earnings constitute "earned" surplus. In brief, the earned surplus account represents the balance of net earnings less transfers to appropriated surplus accounts, payments of dividends and any other intangible assets which may be sanctioned by the board of directors.

"Profit from the sale of capital assets need not be credited to capital surplus. Capital surplus arises from contributions by the owners of a business — profits arising from any subsequent dealings with the public are not in the same class. There is little net or final difference between the profit arising from the sale of normal product and from the sale of surplus plant. Plant or property accounts may have been excessively depreciated so that apparent profits realized from sales do not represent actual net profits."

(2) "There is considerable difference of opinion regarding the propriety of including in earned surplus that representing profits from sales of capital assets. It seems that a position to the contrary could not be sustained by an auditor, as such profits undoubtedly constitute realized gains. They should, however, always be disclosed in a statement designed to show the change in surplus during a period. It is incumbent upon a prospective lender or any one else who may be interested to analyze the past operations in forming an opinion regarding the continuance of profits.

"A premium on an original issue of capital stock should be carried as capital surplus. There should be no objection; however, to regarding as earned surplus a premium on the sale of a stock of an established company, as the premium merely equalizes the equities of the old and new stockholders as is unquestionably subject to distribution as dividends..."

"As has been stated with regard to profits from sales of capital assets, a credit to profit and loss for premiums on sales of stock should always be specifically shown in the auditor's report."

(Note: in Miller v. Payne, 136 N.W. 612 (1912) the court decided that the excess paid in on a new issue of stock over the book value was earnings applicable to the total of the old and the new stock.)

1This is the writer's definition of the Undivided Profits account. All other (except appropriated earned surplus entries) surplus credits or charges are capital surplus items, either realized or unrealized.

2Montgomery, p.330. 3"Whatever might be said as to premiums paid on shares originally issued, it is obvious that the very large premiums received by a corporation on some subsequent issues were paid not as capital, but for the right to share in the profits, surplus, and other earnings... We find nothing which would have prevented the corporation by appropriate votes from using this surplus, profit and loss, undivided profits, or however the premiums may be designated, for any legitimate purpose..." Smith v. Cotting 120 N.E. 177, 1918.

4Bell-Powell, p.311.
A SCHEDULE ON SURPLUS PLATE 199

Gooch and Holt, Inc.
Analysis of Surplus
June 30, 1930

<table>
<thead>
<tr>
<th>Adjust Per Books</th>
<th>Auditor's Final Balance</th>
<th>Schedule L L</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/30/29 to 6/30/30</td>
<td>6/30/30</td>
<td>6/30/30</td>
</tr>
<tr>
<td>No.</td>
<td>Credit</td>
<td>Credit</td>
</tr>
</tbody>
</table>

Balance per G/L 6/30/29

1. 6% Pfd dividend #74 declared 6/17/29, Payable 7/15/29. Not on books at 6/30/29
   - #
   - (15000.00) QQ

2. 6/30/29 Inventory understated
   - #/
   - 3186.91 D-4

3. 6/30/29 Res. for Depreciation understated
   - #
   - (12658.24) H-3

4. Sinking Fund Appropriation for 6/15/29 made on 7/7/29
   - #/#
   - (10000.00) MM QQ

Correct balance 6/30/29

5. Profit for 1930 per books

6. 1930 Depreciation Expense understated
   - 4
   - (1350.81) H-3

7. 1930 Prepaid Assets understated
   - 12
   - 3781.95 F

8. 1930 Inventories understated
   - 21
   - 8107.37 D-4

9. 6/30/29 Inventories understated
   - #/
   - (3186.91) D-4

Correct profit for 1930

10. 1929 Sinking Fd. Appropriation as above
    - #/#
    - (10000.00) 10000.00

11. 1930 Sk. Fd. Appropriation for 6/15/30 not yet on books
    - (10000.00) MM QQ
    - (10000.00)

Correct Sk. Fd. Appropriation for 1930

12. 1929 Pfd dividend #74 as above
    - #
    - (15000.00) MM QQ
    - 15000.00

13. 1930 Pfd. dividend 3 @ 1500 #75-7
    - (45000.00) MM QQ

14. 1930 Pfd. dividend #78 declared 6/17/30 payable 7/15/30. Not on books at 6/30/30
    - 22
    - 15000.00 MM QQ

Correct dividends for 1930

Totals

CHECK

| Reserve for depreciation | 12658.24 |
| " " | 1350.81 |
| Sinking fund appropriation | 10000.00 |
| Prepaid assets | 3781.95 |
| Dividends payable | 15000.00 |
| Inventories | 8107.37 |
| | 11889.32 |
| | 39009.05 |
| | 27119.73 |

656. Explanation and Comments.--Notice particularly the complete tie-up which is made between this schedule and the other schedules. Thus item 1 has been checked to schedule QQ, which is an "Abstract of Directors' Minutes". Note also the "CHECK" at the bottom of the schedule. This shows all of which must be made in the client's June 30, 1930 balance sheet.
(3) "Earned surplus is the balance of the net profits, net income, and gains of a corporation after deducting losses and after deducting distributions to stockholders and transfers to capital stock accounts.

Surplus consists of capital surplus and earned surplus. Capital surplus comprises paid-in surplus and revaluation surplus, that is, all surplus other than earned surplus. Paid-in surplus is the amount received from the sale or exchange of capital stock in excess of its par or stated value; the excess of the par or stated value of capital stock retired over the amount paid therefor; profits on resales of treasury stock; and surplus arising from a recapitalization. Paid-in (or donated) surplus also includes donations to a corporation by its stockholders or others of cash, property and capital stock. Revaluation surplus is the appreciation recognized from an appraisal of fixed assets.

Net profits, net income, and gains include profits from the disposition of any corporate asset (other than the corporation's own capital stock), and arise from transactions resulting in the acquisition of cash or of property which at the time of its receipt may ordinarily be classified as, or converted into a current asset; or from transactions in which the consideration received includes the complete or partial discharge of a liability.

The unqualified terms "surplus" and "capital surplus" are not sufficiently descriptive captions for balance-sheet purposes.

Earned surplus is not properly merged with capital stock or with capital surplus on the balance sheet.

Earned surplus accumulates from the date of incorporation or from the date of a recapitalization when a deficit is absorbed by the authorized reduction of the par or stated value of the outstanding capital stock.

Changes in earned surplus during the fiscal period following the date of the next previous balance sheet are pertinent details on balance sheets net accompanied by a statement of surplus.

Extension and improvement reserves, reserves for the retirement of corporate securities and other appropriated earned surplus items, although not available for distribution to stockholders, are properly shown as subdivisions of earned surplus on the balance sheet. Where it is provided that retirements of a preferred stock or bond issue are to be made "out of earnings" and where it is the intent of the provision that earnings of an equivalent amount are to be retained in the business, such earnings should be segregated and distinguished on the balance sheet from unappropriated earned surplus.

Dividends paid in cash or property are properly charged against earned surplus. Stock dividends are reductions of earned surplus or of capital in accordance with the authorization therefor. A loss resulting from the retirement of capital stock or from the sale of treasury stock is a reduction of paid-in or of earned surplus, according to the nature thereof. Disclosures are necessary when dividends, losses, or expenses are deducted from capital surplus.

Profits from the sale of fixed assets should be disclosed in the year of the transaction if the amounts are relatively significant.

When a corporation states its fixed properties on the basis of appraisal values which exceed the former book values, depreciation computed on the appraisal values is properly charged against operations. If a corporation has not in any way legally or morally obligated itself to maintain the assets at their increased valuation out of earnings, depreciation on the excess of appraisal over book values may, by reason of past practice, be charged directly against revaluation surplus, provided a disclosure is made.

Surplus of a subsidiary corporation accumulated prior to the date of the acquisition of its stock by a parent corporation is not a part of consolidated earned surplus. A dividend declared out of such surplus by a
subsidiary is applicable by the parent corporation as a reduction of its investment in the subsidiary.

"Occasions will arise where the practice as herein set forth can not be strictly complied with, due to properly authorized corporate action under permissive statutes, or to agreements between a corporation and its bankers or investors. In these instances adequate disclosures must be made. A disclosure may be general or specific and it may be limited to the year of the transaction or continued, according to the relative amount and significance of the item."

In the writer's opinion, which is contrary to the weight of decision expressed above, the profit on the sale of fixed assets and the premium on subsequent issues of capital stock are both capital surplus. That these two items are not exactly the normal elements of a profit and loss statement is seemingly recognized above by the requirements that they be fully disclosed in the year in which they occur. It is the writer's contention that this distinction should be maintained in the future statements. For example, is it not true that the first of the following surplus sections is far more informative than the second one?

(a)

<table>
<thead>
<tr>
<th>Surplus:</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Profit on sales of securities</td>
<td>$14,869.24</td>
</tr>
<tr>
<td>Earned Surplus:</td>
<td></td>
</tr>
<tr>
<td>Balance, January 1</td>
<td>$18,469.83</td>
</tr>
<tr>
<td>Less-Operating Deficit</td>
<td>$16,817.41</td>
</tr>
<tr>
<td></td>
<td>$1,652.42</td>
</tr>
<tr>
<td></td>
<td>$16,521.66</td>
</tr>
</tbody>
</table>

(b)

<table>
<thead>
<tr>
<th>Surplus:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, January 1</td>
<td>$33,339.07</td>
</tr>
<tr>
<td>Less-Operating Deficit</td>
<td>$16,521.66</td>
</tr>
</tbody>
</table>

The first presentation, in the absence of additional information, shows that earnings from operations have barely been able to keep abreast of the dividend payments and the operating deficits. And, except for an unusual stroke of good luck in connection with the sale of certain side-line investments at a profit, there would be some genuine reason for believing that, as a matter of fact, the capital stock had been eaten into. (The figure $1,652.42 is so small as to be negligible considering that the balance sheet contains so many estimates).

The second delineation of the surplus gives a much healthier picture and is to that extent misleading. The normal operating profits appear to have been considerably in excess of the dividend requirements and the operating losses to date.

Of course the writer realizes that the whole history or worth of a company can not be portrayed in its financial statements. It is incumbent on the interested party to make a full investigation for a number of prior years; nevertheless, the auditor should go as far in his explanations as it is possible to go.

1Report to the Council of the American Institute of Accountants (dated Aug. 26, 1930) by Special Committee on Definition of Earned Surplus.

2These types of capital surplus are, however, available for dividends both from a legal and an accounting standpoint, whereas certain other types are NOT.
A SCHEDULE ON EARNED SURPLUS (1st type) PLATE 200

Schroeder & Schroeder, Inc.
Earned Surplus
Audit for Two Years Ended Dec. 31, 1930

<table>
<thead>
<tr>
<th></th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Balance 12/31/28 per G/L and prior auditor's report</td>
<td>896439.16</td>
</tr>
<tr>
<td>ADD - Profit for 1929 per books</td>
<td>251689.43</td>
</tr>
<tr>
<td>Adjustments applicable to 1929</td>
<td></td>
</tr>
<tr>
<td>2. Net Inventory Omissions</td>
<td>G-4 25468.51</td>
</tr>
<tr>
<td>6. Excess Depreciation</td>
<td>K-5 17091.43</td>
</tr>
<tr>
<td></td>
<td>294249.39</td>
</tr>
<tr>
<td></td>
<td>1190688.53</td>
</tr>
<tr>
<td>3. DEDUCT - Expenses charged to Plant Assets</td>
<td>K-2 5286.49</td>
</tr>
<tr>
<td>Dividends 8% on $2000000</td>
<td>#2, 3, 4, 5, 160000.00</td>
</tr>
<tr>
<td>#14 - #17 incl.</td>
<td>#1 JJ 45000.00</td>
</tr>
<tr>
<td></td>
<td>21c286.49</td>
</tr>
<tr>
<td></td>
<td>980402.04</td>
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<tr>
<td></td>
<td>269845.91</td>
</tr>
<tr>
<td></td>
<td>1250256.95</td>
</tr>
<tr>
<td>Balance 12/31/29</td>
<td></td>
</tr>
<tr>
<td>ADD - Profit for 1930 (adjusted)</td>
<td>MM-1</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Dividends 8% on $2000000</td>
<td>#7, 8, 9, 160000.00</td>
</tr>
<tr>
<td>#18 - 21 incl.</td>
<td>#6 JJ 45000.00</td>
</tr>
<tr>
<td></td>
<td>205000.00</td>
</tr>
<tr>
<td></td>
<td>1045256.95</td>
</tr>
<tr>
<td>Balance 12/31/30 per G/L and our report</td>
<td></td>
</tr>
</tbody>
</table>

AUDIT PROCEDURE

2. Adjustment #18 1. Hartwell, Maxton & Co., C.P.A.'s We satisfied ourselves
6. " #31 3. Adjustment #30 that this opening balance is correct.
4. The dividends were checked to our abstract of
   Directors' Minutes as per pages indicated above.
5. These 2 appropriations were checked to our abstract of Directors' Minutes
   as per pages #1 and #6 and to our analysis sheet JJ on Sinking Fund Reserve.

658. Explanation and Comments. -- This corporation had not been audited since December 31, 1928. The auditors for that year were Messrs. Hartwell, Maxton & Co.
   The present engagement called for a certified balance sheet, and profit and
   loss statement for 1930. No statements were requested for 1929.
   Note how each figure is substantiated by an analysis sheet (letters), or by
   a reference to the pages of the Abstract of Directors' Minutes (numbers).
The Clarkson Thread Mills, Inc.

Earned Surplus

B/S Audit for Year Ended Dec. 31, 1930

Schedule QQ

<table>
<thead>
<tr>
<th>Credit</th>
<th>378736.28</th>
</tr>
</thead>
<tbody>
<tr>
<td>To B/S</td>
<td>378736.28</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Balance per G/L 12-31-30</th>
<th>378736.28</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per G/L and our papers 12/31/29</td>
<td>1189656.87</td>
</tr>
<tr>
<td>1925 Federal Tax Refund (Interest $ 1248.92)</td>
<td>8672.46</td>
</tr>
<tr>
<td></td>
<td>1198329.35</td>
</tr>
</tbody>
</table>

Less - Operating Loss

| Appropriation to Reserve for Retirement of Preferred Stock, J.V. #8284 | 40000.00 |
| Appropriation to Reserve for Bond Sinking Fund, J.V. #8684             | 85000.00 |
| Appropriation to Reserve for Pension Fund, J.V. #9822                  | 25674.72 |

Dividends:

| 2% paid Feb. 1 Pfd. $ 1,000,000                                      | 20000.00 |
| May 1                                                                    | 20000.00 |
| Aug. 1                                                                   | 20000.00 |
| Nov. 1                                                                   | 20000.00 |
| 1% Paid Feb. 1 Common $ 1,000,000                                      | 10000.00 |
| May 1                                                                   | 10000.00 |

Balance per G/L 12/31/30 as above

| 378736.28 |

659. *Explanation and Comments.*—Note that the final result is stated clearly at the beginning of the schedule, even to the extent of showing that it is a credit balance (*Credit*).

Note also the detailed manner in which the entries are crossed indexed to other schedules, to the abstract of the Minutes of the Board of Directors, (the various ZZ schedules), and to the balance sheet.
As to premiums paid in on sales of stock of an established company being earned surplus (assuming only earned surplus on the balance sheet), the writer is of contrary opinion. Earned surplus credits should come from EARNINGS, not from sums paid in even though those amounts include theoretically a sum sufficient (or less or greater) to equal the book value of the earned surplus attached to the old shares.

658. See Plate 200.

659. See Plate 201.

660. Capital Surplus.—Capital Surplus arises from (1) unrealized appraisal surplus, (2) capital stock assessments, (3) capital stock premiums, (4) donations of all kinds, (5) conversion of one kind of company security for a lesser amount of the same or different class, or some of both, (6) forfeiture of stock subscriptions, (7) sale of investments at a profit, (8) etc.

It is sometimes unqualifiedly stated that all capital surplus is not available for dividends. A review of the opinions of eminent authorities shows, however, that the matter can not be settled without reference to the corporation act of the state of incorporation, and a majority of these permit the disbursement. On the other hand, the weight of opinion in regard to sound accounting treatment is that certain capital surplus items (such as unrealized capital surpluses, original paid-in capital surplus plus additions thereto to date) constitute additional capital not available for dividends; hence, payments out of them morally require an explanation on the dividend checks or notices. In this connection it is interesting to note that the Ohio General Corporation Act (1927) reads "In case all or any cash dividend is paid out of such paid-in or capital surplus, the stockholders shall at the time of payment, be notified of that fact."

In a balance sheet presentation (accompanied by a subschedule on surpluses), the total of the capital surplus may be given as a single figure, but in the general ledger the amounts should be kept in separate accounts, especially if they are sizable. Moreover, the capital surplus may not be used to absorb an operating deficit; the two accounts must be stated separately, the deficit being deducted from the capital surplus on the face of the balance sheet. Finally, the term surplus without qualification means earned surplus; hence, capital surplus must always be earmarked.

In conclusion, the writer presents his idea of a proper presentation from an accounting standpoint of the surplus accounts. Observe that under this plan there is neither an Earned Surplus nor a Capital Surplus account; these are merely balance sheet captions.

1See Appendix C - Sec. 12-#2; Sec. 15 - #6.

2In short, accounting treatment of surpluses available for distribution is much more restrictive than the general run of corporation laws.
CAPITAL

CAPITAL STOCK:
7% Cumulative Preferred - Par $100
Authorized, issued, and outstanding $xx

No Par Value Common - Authorized 100,000 Shares:
95,000 Shares issued and outstanding xx $xx

SURPLUS:
Earned (Exhibit A-3):
Unappropriated:
Undivided Profits $A

Appropriated:
Reserve for Appraised Increase of Plant $B
Reserve for Bond Sinking Fund C
Reserve for Retirement of Preferred Stock D
Reserve for Extension of Plant E F $G

Capital (Exhibit A-4):
Distributable:
Forfeitures on Stock Subscriptions1 $H
Profit on Sales of Plant Property I
Profit on Sales of Securities J
Profit on Transactions in Treasury Securities K
Share of Paid-In Premium on Subsequent Issues of Common Stock L
Total $M

Non-distributable:
Paid-In on Original Issue of Common Stock (Adjusted to date) $N
Donated - Land Site O
Excess of Appraised Sound Value of Plant Over Net Book Value P Q R xx xx

1Possibly non-distributable capital surplus.
STATEMENT OF EARNED SURPLUSES

EXHIBIT A - 3

Undivided Profits:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, January 1, 1901</td>
<td>$xx</td>
</tr>
<tr>
<td>Adjustments Applicable to 1900 1</td>
<td></td>
</tr>
<tr>
<td>To January 1 Inventory</td>
<td>$xx</td>
</tr>
<tr>
<td>To Depreciation Allowance - Plant</td>
<td></td>
</tr>
<tr>
<td>Corrected Balance, January 1, 1901</td>
<td>xx xx</td>
</tr>
<tr>
<td>Profit for the Year 1901 (Exhibit B)</td>
<td>$xx</td>
</tr>
<tr>
<td>Profit on Retirements of Plant Property 2</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$x A</td>
</tr>
</tbody>
</table>

DividendsDeclared:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>7% on Preferred Stock</td>
<td>$xx</td>
</tr>
<tr>
<td>$10 per Share on Common Stock</td>
<td>xx</td>
</tr>
<tr>
<td>Portion of Goodwill Written Off</td>
<td>xx</td>
</tr>
</tbody>
</table>

Appropriations:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>To Reserve for Bond Sinking Fund</td>
<td>$Y</td>
</tr>
<tr>
<td>To Reserve for Retirement of Preferred Stock</td>
<td>Z xx xx $A</td>
</tr>
</tbody>
</table>

Appropriated:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve for Appraised Increase of Plant: Balance, January 1, 1901</td>
<td>$xx</td>
</tr>
<tr>
<td>Received from Appraisal of Plant account</td>
<td>S B</td>
</tr>
<tr>
<td>Reserve for Bond Sinking Fund: Balance, January 1, 1901</td>
<td>$xx</td>
</tr>
<tr>
<td>Received on Appropriation #7</td>
<td>Y C</td>
</tr>
<tr>
<td>Reserve for Retirement of Preferred Stock: Balance, January 1, 1901</td>
<td>$xx</td>
</tr>
<tr>
<td>Received on Appropriation #2</td>
<td>Z D</td>
</tr>
<tr>
<td>Reserve for Extension of Plant (No Change)</td>
<td></td>
</tr>
<tr>
<td>Total of Earned Surpluses (To Exhibit A)</td>
<td></td>
</tr>
</tbody>
</table>

1 Small adjustments of prior year should be absorbed in current profit and loss.

2 Possibly a correction to the January 1, 1901 balance.
### Distributable:

- **Forfeitures on Stock Subscriptions**: $H
- **Profit on Sales of Plant Property**: $I

### Profit on Sales of Securities:

- **Balance, January 1, 1901**: $XX
  - Profit on Sale 10,000 Common Shares of T.P. Jordan, Inc.: $X
- **Profit on Transactions in Treasury Securities**: $K

### Share of Paid-in Premium on Subsequent Issues of Common Stock:

- **Balance, January 1, 1901**: $XX
- **Equitable Proportion on 10,000 New Shares Issued**: $XX
  - **Total**: $M

### Non-Distributable:

- **Paid-in on Original Issue of Common Stock**:
  - **Balance, January 1, 1901**: $XX
  - Equitable Proportion on 10,000 New Shares Issued: $XX
- **From Donated Land Site**: $0

- **From 1899 Appraisal of Plant**:
  - **Balance, January 1, 1901**: $XX
  - Current Depreciation of Appreciation - Transferred to Reserve for Appraised Increase of Plant (Exhibit A-3): $P
  - **Total of Capital Surpluses (To Exhibit A)**: $R

---

**# No change in 1901**

---

661. See Plate 202.
662. See Plate 203.
663. See Plate 204.
664 See Plate 205.
664a. Audit Program.

1. Keep constantly in mind that the auditor's chief problem in connection with NETWORTH is to divide it into its divisions and then to draw up an accurate descriptive picture of these several parts, including a review of the changes in them during the period under audit.
A SCHEDULE ON DONATED CAPITAL SURPLUS  PLATE 202

The Gregory Soap Works
Donated Capital Surplus

| Harper | 5-17-30 |

B/S Audit for Year Ended April 30, 1930  Schedule GG

<table>
<thead>
<tr>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per G/L 4/30/30</td>
</tr>
<tr>
<td>To B/S</td>
</tr>
</tbody>
</table>

This surplus arises from a donation of 28 acres of land by the city of Illiniois as of 12-31-29 in accordance with a contract made with the city on 1-1-20. See schedule #15 in our permanent file of working papers on this Company.

This value was authorized by the Board of Directors on Feb. 17, 1930, page 317 of the minute book.

Assessed value of the land per the tax bill is $28,500. Valuation in Illiniois runs at about 80% of true estimated worth.

661. Explanation and Comments.—Note that the surplus was not taken up until the land became the absolute property of the Company. From January 1920 to December 1929 the facts were stated in a footnote on the balance sheet.

Observe that mention is made of a "permanent file of working papers". Such a file would have in it, among other papers, the following ones:

(a) An abstract of those by-laws which affect the auditor
(b) A list of the accounting records, etc. with the names of those who keep them
(c) The signatures of those authorized to sign various documents, notes, checks, vouchers, etc. with notation as to their authority.
(d) A copy of the Memorandum of Engagement
(e) The annual questionnaire regarding the system of internal check
(f) A copy of the Letter of Engagement
(g) A chronological abstract of Directors' Minutes
(h) An abstract of the Charter
(i) A chronological abstract of the Stockholders' Minutes
(k) An abstract of the Bond Indentures
(l) A copy of the Opening Journal Entries
(m) A list of the important officers and their offices
(n) An abstract of contracts of current value
Net Profit for the year

\[ \$4,896,329.87 \]

**Deduction of Profit and Loss Items:**

- Loss on Retirement of Machinery \( \$29,607.83 \)
- Amortization of Organization Expense \( 14,839.24 \)
- Amortization of Obsolete Plant \( 35,276.40 \)
- Loss-Depreciation of Appreciation of Plant \( 15,693.82 \)
- Profit on Sale of Securities \( 6,887.45 \)

\[ \text{Total} \quad \$79,723.47 \]

**Surplus, January 1, 1919**

\[ \$11,018,598.35 \]

**Addition of Surplus Adjustments:**

- Refund on 1915-1916 Federal Taxes \( \$80,469.12 \)
- Miscellaneous \( 1,965.42 \)

\[ \text{Total} \quad \$82,434.54 \]

**Loss-Adjustment of 1916-1918 Depreciation**

\[ 7,659.74 \]

\[ 74,774.80 \]

\[ 11,093,372.15 \]

**Total**

\[ \$15,932,560.85 \]

**Deduction of Appropriations:**

- 7% Preferred Dividends \( \$70,000.00 \)
- 10% Common Dividends \( 200,000.00 \)
- Sinking Fund Reserve \( 47,000.00 \)

\[ \text{Surplus, December 31, 1929 (Exhibit A)} \]

\[ \$15,615,560.85 \]

662. **Explanation and Comments.**—Whereas most profit and loss statements end with the net profit figure (here \$4,896,329.87), this plate shows one with the earned surplus account attached. In small businesses only the balance sheet and the profit and loss statement (terminated at the net profit figure) are apt to be rendered. And the surplus is often poorly stated in a single figure in the balance sheet,—hence the changes in surplus are never presented in statement form. Large businesses, on the other hand, customarily prepare the three statements; i.e., balance sheet, statement of profit and loss, and statement(s) of surplus.

"Extraordinary profits and losses are often charged or credited directly to surplus; but it is better practice to charge or credit them to profit-and-loss account, especially if they are losses related to operations or operating assets. Losses or profits on investments outside the regular business of a corporation, goodwill written off and a few similar debits and credits under certain conditions go directly to surplus account, but even in such cases there are advantages in showing them in the profit-and-loss statement. Practice should be consistent; if profits on sale of securities bought for investment are taken into the profit-and-loss account then losses of a similar kind should also be taken in the same way."—F.W. Thornton.
A RECONCILIATION OF SURPLUS  PLATE 204

THE HOLT MANUFACTURING COMPANY
Reconciliation of Surplus
For the Two Years Ended April 30, 1931

Surplus per General Ledger, April 30, 1930  $69,871.59
Less--Write up of Goodwill  10,000.00
Net  $59,871.59

Deduct: Under-statement of 1930 Expenses:
Depreciation, Buildings  $3,641.23
Depreciation, Machinery  9,648.31
Purchases  6,100.05
Accrued Taxes Payable  1,769.12
Bad Debts Expense  887.57
Accrued Interest Payable  1,659.41
Total  $25,705.69

Less: Under-statement of Sales
Capital Items Charged to Repairs  $13,607.19
Accrued Interest Receivable  4,985.37
Total  $20,781.09

Net Profit for Year Ended April 30, 1930  $20,781.09
Deduct --Federal Income Tax  $7,069.47
Dividends payable May 15, 1930  10,000.00
Total  $17,069.47

Adjusted Surplus Balance May 1, 1930  $356,946.99

Deduct --Net Loss 1931 (Exhibit B)
Dividends payable May 15, 1931  $7,609.89
Loss on Retirement of Machinery  1,425.42
Total  $9,035.31

Adjusted Surplus Balance, April 30, 1931 (Exhibit A)  $20,842.21

Explanation and Comments.--This plate shows a reconciliation of surplus for two years, the entire lifetime of the corporation. Notice that the adjustments are so listed as to arrive at the net profit (per auditor) for the year ended April 30, 1930 as well as for 1931.

The accounts for 1931 were not closed when the auditor arrived.
A SCHEDULE ON RESERVE FOR CONTINGENCIES

HARPER & HARPER, INC.
Reserve for Contingencies
B/S Audit for Year Ended Dec. 31, 1930
Schedule KK

<table>
<thead>
<tr>
<th>Description</th>
<th>Balance per G/L 12/31/30</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per G/L 12/31/30</td>
<td>450187.00 (To B/S)</td>
<td></td>
</tr>
</tbody>
</table>

Note: Place this item among the surplus reserves as we can not cover any contingencies to be provided for in this manner. See below.

Balance per G/L and our working papers 12/31/29 | 350187.00
Add - Appropriation from Surplus | (QQ) (MM) 100000.00
Balance per G/L 12/31/30 | 450187.00

Audit Procedure

The appropriation was verified in the directors' minutes per Schedule QQ, and the debit was traced to Surplus per Schedule MM.

This reserve is not a provision for any known contingencies. It is a reservation of surplus for possible losses. It is a part of Earned Surplus.

Signed Peter T. Harper
Treas.

664. Explanation and Comments.—Notice particularly (1) that the appropriation was traced definitely both to the Directors' Minutes QQ and to the analysis of surplus, schedule MM; and (2) that the unusual was resorted to in getting the treasurer to sign as to the nature of the reserve, so that the auditor could feel thoroughly free to place it on the balance sheet among the surplus reserves as desired by the company.
(2) In a balance sheet audit, do not lose sight of the fact that the Profit and Loss account is an element of surplus. Accordingly, a review and scrutiny, plus certain tests (such as of the Repairs and Maintenance account), should be made.

(3) In the case of appropriated reserves, check changes in them against authorizations of the board of directors, or the requirements of the provisions of a stock or bond issue, etc.

(4) In general, take up profit on work-in-process done on a "cost plus" basis.

In general, do not take up profit on work-in-process or special orders or on firm sales contract when both the unit of work and the number of units in process are relatively small.

In general, take up periodic profits on long term contracts where the unit of work is large.

(5) In general, profit may be taken up on finished goods which have been sold provided they have been segregated, etc. so that the title has legally passed to the buyer.

(6) Any substantial profits on losses arising from transactions in treasury stock or from the sale of an asset should be entered in suitably named capital surplus accounts. (Minority opinion.) Profit and Loss arising on the retirement of a worn out or obsolete asset may be entered in the Un-divided Profits account on the assumption that the difference is due to incorrect depreciation. If this is not a warranted assumption, enter the same, if large, in a capital surplus account.

(7) Remember that "The unqualified terms "surplus" and "capital surplus" are not sufficiently descriptive captions for balance sheet purposes. Do not merge earned surplus with capital stock or with capital surplus.

(8) Always show changes in the surplus accounts on face of balance sheet (or subschedules) when no report (text material) is rendered.

(9) Always disclose any dividends, losses, or expenses that are deducted from capital surplus. Each successive statement should show it as the condition exists. (Minority opinion.)

(10) Remember that: "Earned surplus accumulates from the date of incorporation or from the date of a recapitalization when a deficit is absorbed by the authorized reduction of the par or stated value of the outstanding capital stock." An apparent exception is when a new corporation is the same in substance as the old one except for the name; e.g. Smith, Inc. becomes The Thomas E. Smith Co., Inc..

(11) Those who treat profits and losses from the sale of fixed assets as earned surplus items must be certain to disclose them at least in the year of the transaction if the amounts are relatively significant.

(12) Remember that: "Surplus of a subsidiary corporation accumulates prior to the date of the acquisition of its stock by a parent corporation is not a part of consolidated earned surplus. A dividend declared out of such surplus by a subsidiary is applicable by the parent corporation as a reduction of its investment in the subsidiary."

(13) Remember that: In so far as possible (feasible) adjust capital and earned surplus accounts (for proportion of book value attached to stock) to determine correct profit and loss on treasury stock transactions.

(14) When the cost of treasury stock is prohibited by law from reducing the capital (i.e. the cost is not to exceed the earned surplus), deduct at par the treasury stock from the outstanding amount and then state in parenthesis before the surplus figure the amount to which the surplus is subject, for dividend purposes, because of the net cost of the reacquired stock.

(15) "On a first audit the working papers should contain a summary of the surplus accounts from the earliest available record or from the date of a reorganization."
(16) Absorb small prior year expenses into current profit and loss for "is such unanticipated expenses be regularly charged against surplus and omitted from profit and loss the operations over a period of years will not show actual results."

(17) If possible show extraordinary debits and credits not as surplus items but as profit and loss items stated separately below the usual NET PROFIT figure.

(18) If a dividend has been declared out of anything but earned surplus, insist on having the stockholders notified of its exact character. Show the true situation on the present balance sheet (or subschedule) and on the future ones until such time as the earned surplus can absorb the dividend. Exceptions to this rule are: (1) limited life projects (2) businesses in liquidation etc...

(19) When a formal reduction of par on stated value of stock results in a capital surplus for the purpose of wholly eliminating an operating deficit, show the deficit as a subtraction from the capital surplus; NEVER show the net amount alone. In the future presentations indicate that this capital surplus is NET of operating deficit. If the capital surplus is not sufficient to absorb the entire operating deficit show the capital surplus as a reduction of the deficit; NEVER show the net amount alone. In the future presentations indicate that this deficit (until eliminated) is NET of this capital surplus. In either case indicate from what date the earned surplus begins.

E.G.: - Earned Surplus:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance to January 1, 1935 since 1933</td>
<td>$xx</td>
</tr>
<tr>
<td>Profit for year 1935 (Exhibit B)</td>
<td>xx</td>
</tr>
</tbody>
</table>

(20) Do not charge organization expenses, losses (in excess of credit balance of account) on sales of fixed assets, etc. into capital surplus accounts. Keep each kind of surplus account free of foreign items.

(21) Always make it a point to present schedules showing the current changes in each capital and earned surplus account. Make certain that no operating charges are buried in capital surplus accounts. Require in as many instances as seems proper that the changes in the surplus accounts be authorized by the board of directors or other proper body.

(22) See that the balances of the various surplus accounts at the beginning of the period are in agreement with those in the balance sheet of the prior period when adjusted by the items which the client would not, etc. take up on the books of account.

(23) Analyze and verify back to primary data each and every entry. Reject "foreign"items, particularly those properly applicable to the profit and loss statement. Review the latter for items which are true surplus adjustments.

(24) Ascertain who must approve surplus adjustments. See that each journal voucher contains these signatures.
REVIEW QUESTIONS

1. Certain prepayments are omitted from a company’s financial statement. Which statement, the profit and loss or the balance sheet, will likely be the more incorrect on this account?

2. Name the more common entries in the surplus accounts.

3. What items in your opinion should be included in the earned surplus account?

4. What items in your opinion should be classified as capital surplus?

5. Can capital profits be paid out in cash dividends?

6. In the analysis of the various surplus accounts, what is the auditor’s chief concern?

7. Into how many main groups should surplus be divided in a balance sheet presentation?

8. Criticize fully the following:

SUNDAY RESERVES, DECEMBER 31, 1930

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, December 31, 1939</td>
<td>$12,746,602.55</td>
</tr>
<tr>
<td>Deduct - Depreciation of Plants, Additional</td>
<td>542,631.10</td>
</tr>
<tr>
<td>Balance, December 31, 1930</td>
<td>$12,203,971.45</td>
</tr>
</tbody>
</table>

9. Criticize fully the following:

Appropriated Surplus: Reserves for amortization of properties and for depreciation of equipment $9,689,920.67
Surplus including net earnings for the year 1928 $1,932,621.38
Less dividend to U.S.Rubber Company from earnings for 1928 1,000,000.00 322,621.38
TOTAL SURPLUS $10,622,542.05

10. Comment fully on the following:

"During previous years, six of the smaller factories of the Company have been discontinued as manufacturing units, and during the past year consideration has been given to the consolidation of activities which will permit the closing of additional plants. Provision has been made from the Surplus Account for such adjustments as may be necessary in connection with the disposition of these factories and for the improvement of facilities in certain other units. Provision has also been made for the disposition of obsolete machinery and equipment including obsolete tire molds, as well as for the general contingencies. The amount provided for the foregoing purposes is $10,000,000 as stated in the Consolidated General Balance Sheet."

11. Comment fully on the following:

---

11. (Continuation)
Deficit after Dividends .................................. $4,706,403.97
Paid in Surplus:
Net Premium received on sale of
International Paper Company 7%
Preferred Stock ........................................... $212,036.07
Conversion of International Paper
Company 6% Preferred into 7%
Preferred Stock ........................................... 30,470.00
Surplus Decrease ........................................... $4,463,897.90
Surplus, January 1, 1928 22,648,543.81
Surplus, December 31, 1928 $ 18,184,645.91

12. Criticize fully the following:¹

RESERVES:
Pension and benefit fund .................................. $ 501,782.23
Contingent depreciation of inventories ................. 1,361,474.93
Special reserve for doubtful accounts ................. 100,000.00
Special reserves against contingencies and
expenses properly chargeable to profits of
previous years ............................................ 75,140.15
Special reserves set up against plants and
properties purchased .................................... 362,033.04
Special reserves against furniture, fixtures,
office appliances and automobiles ................. 300,474.05
Special reserves against foreign investments 663,215.99
Miscellaneous reserves ................................ 602,340.36
Reserve for Income and Excess Profits Tax
for 1919 (carried forward from June 31, 1919) 826,957.50
$ 4,822,418.25

13. Comment fully on the following:²

SUNDAY RESERVES, DECEMBER 31, 1928

Balance December 31, 1927 $14,819,232.61
Deduct-Loss in 1928 on 1920 Contracts $1,034,246.49
Depreciation of Plants,
Additional 500,000.00 1,542,246.49 $13,284,986.12

14. Which one of the following methods for recording stock dividends do you favor? Why?

1. "The issuance of the additional stock described as a stock dividend, without the transfer to capital of any sum whatsoever, either from capital surplus, from earnings, or from earned surplus;
2. "The transfer to capital account from capital surplus of a nominal sum per share issued;
3. "The transfer to capital account from capital surplus of an amount per share issued equal to the theretofore stated value or par value of the stock, per share;
4. "The transfer to capital account from earnings or earned surplus of a nominal amount per share issued;
5. "The transfer to capital account from earnings or earned surplus of an amount per share issued equal to the theretofore stated value or par value of the stock per share;
6. "The transfer to capital account and/or capital surplus from earnings or earned surplus of an amount per share issued equal to the theretofore stated value or par value of the stock per share, plus the theretofore capital surplus per share;
7. "Particularly with companies having large uncapitalized tangible or intangible assets, the transfer to capital account and/or capital surplus from earnings or earned surplus of an amount per share issued greater than the sum of the theretofore capital per share plus capital surplus per share and less than the market value per share;
8. "The transfer to capital account and/or capital surplus from earnings or earned surplus of the theretofore entire book value per share, including earned surplus; (note - if earned surplus were 100% of capital, this method would exhaust earned surplus upon payment of a 50% stock dividend);
9. "The transfer to capital account and/or capital surplus from earnings or earned surplus of an amount per share issued equal to the market value of the stock upon some convenient near-by date."--J.H.B. Hoxsey, Journal of Accountancy, Oct. 1930 (p. 265).

15. What is your opinion of the advisability and/or legitimacy of the following procedures? Why?

"The Surplus Account contains the following adjustments:

A credit of $1,759,495.68, resulting from acquisition of properties and business of The Newport Company, represents the value of the net assets acquired (exclusive of Goodwill) in excess of par value of debenture stock issued by your company therefor.

A debit of $5,354,104.61, to adjust book value of ammonia, dyestuffs and other patents and processes to a nominal amount as a matter of policy.

A debit of $8,484,087 reduces the value at which your company carries its holdings of 9,981,220 of General Motors Corporation common stock to $178,662,828, or from $18.75 a share to $17.90 a share. This is consistent with your company's policy of adjusting each year the value of this investment to a figure closely corresponding to its net asset value as shown by Balance Sheet of General Motors Corporation at December 31st of the preceding year. The decrease in its net asset value represents principally your company's portion of the appropriation of surplus in 1930 by General Motors Corporation for rearrangement of its preferred capital liability coincident with exchange of its several classes of preferred stock for the new $5.00 series preferred stock."--1931 Annual Report, E.I.Dupont De Nemours & Co.
REVIEW QUESTIONS (Continuation)

16 (Continuation)

"The Surplus Account contains the following adjustments:

"A credit of $22,457,745 resulting from adjustment of the value of your company's investment in General Motors Corporation common stock on March 31, 1930, from $164,690,150 to a new figure of $187,147,875, which closely corresponded to its net asset value as shown by the Balance Sheet of General Motors Corporation at December 31, 1929; on the basis of 9,981,220 shares owned, this figure represents a valuation of $18.75 a share.

"A credit of $7,767,060 represents the difference between selling price ($80) and par value ($20) of 128,451 shares of common stock issued and sold to employees under the Executives' Trust and Bonus Plans.

"A credit of $21,353,220 represents premium (excess over par value) received for 355,687 shares of common stock issued under subscription offer referred to on page 10.

"A credit of $7,684,228, resulting from acquisition of The Roessler & Hasslacher Chemical Company, represents value of the net tangible assets acquired in excess of par value of common stock issued by your company therefor." --1930 Annual Report (Note: The balance sheet states the Surplus as a single figure.)

16. What is your opinion of the following?

"1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as the packing-house industry) in which, owing to the impossibility of determining costs, it is a trade custom to take inventories at net selling prices, which may exceed cost.

"2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

"3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

"4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company." --A. J.

17. What is your opinion of the following classification (E-Earned Surplus; C-Capital Surplus)?

"Of the various items to be found credited to the "Surplus" account some of the more common are:

a. Acquisition of the capital stock of a subsidiary company from outside interests at a price less than the book value of the shares acquired. (C)
17. (Continuation)
"b. Adjustments during a fiscal period which increase the stated profit of a previous period. (E)
"c. Adjustment of a reserve for doubtful accounts and notes receivable, when the amount of the reserve as established is excessive. (E)
"d. Adjustment of capital stock of no-par value to a par-value basis, when such latter value is less than the amount originally received for the no-par-value stock. (C)
"e. Adjustment of reserves for Federal and state income and profits taxes to the amount actually paid, when the amount paid is less than the reserve established. (E)
"f. Amounts received from lawsuits reduced to judgments, if applicable to transactions of the past fiscal periods. (E)
"g. Amounts received as compromises on lawsuits commenced, if applicable to past fiscal periods. (E)
"h. Assessments on capital stock outstanding after its par value has been paid in. (C)
"i. Credits resulting from the adjustments required to bring to par those securities, issued or assumed by the company, reacquired at a cost less than par. (C)
"j. Credits arising from refunds or rebates of income and profits taxes. (E)
"k. Credits arising as a result of debit adjustments to all valuation reserves which contain amounts established as a result of excessive charges against the profits of the past fiscal periods. (E)
"l. Credits arising from the conversion of stock. (C)
"m. Insurance received upon the death of officers, directors, employees, etc., who have been insured by the company for the benefit of the company. (E)
"n. Donated surplus items. (C)
"o. Paid-in surplus items. (C)
"p. Payments received on stock subscriptions, if forfeited on account of failure to complete contract. (C)
"q. Premium received from the sale of capital stock. (C)
"r. Premiums received on the capital stock of other companies at the time of retirement or redemption of that stock. (C)
"s. Profits from operations transferred to "Surplus." (E)
"t. Profit on the sale of capital assets where the amount of assets sold is abnormally large. (C)
"u. Profit from the sale of treasury stock which has been purchased for value. (C)
"v. Profit from the sale of treasury stock received as a gift. (C)
"w. Recovery of bad accounts and notes receivable which were charged off against profits in a prior period. (E)
"x. Reversion to surplus of the reserve created out of profits for the retirement of preferred stock. (E)
"y. Reversion to surplus of the reserve created out of profits for contingencies. (E)
"z. Reversion to surplus of the reserve for sinking fund, created out of profits. (E)
"aa. Reappraisal and write-up in value of certain assets. (C and/or E)
"bb. Transfer of surplus reserve accounts or portions thereof to surplus. (E or C)
"cc. Unclaimed wages and salaries reverting to the company. (E)
"dd. Dividends which have been unclaimed. (E)
"ee. Unclaimed interest on bonds payable. (E)
17. (Continuation)

"ff. Unclaimed liabilities. (E)
"gg. Unextinguished premiums, received on funded debt, taken into sur
plus. (C)
"hh. Where the value of tangible assets received for capital stock is un­
questionably more than the par value of the stock issued therefor;
the surplus represented by the excess value received. (C)
"ii. When the capital stock outstanding is being reduced - the difference
between the par value and the amount paid the holders, when the
amount paid the holders is less than par. (C)

"Of the various items to be found debited to the "Surplus" account, some
of the more common are:
"a. Abnormal write-off of any asset account. (C)
"b. Adjustment of surplus for additional income and profits taxes "Fed­
eral and state) paid or payable, which are applicable to the profits
of prior years. (E)
"c. Adjustments, during the period, which diminish the stated profits
of the prior fiscal periods. (E)
"d. Amounts paid on lawsuits, reduced to judgments, if applicable to
prior fiscal periods. (E)
"e. Amounts paid as compromises for lawsuits commenced, if applicable
to prior fiscal periods. (E)
"f. Cash dividends paid from surplus. (E or C)
"g. Discount on capital stock extinguished through surplus. (E)
"h. Exchanging old par-value stock outstanding for new no-par-value
stock. (C)
"i. Loss incurred through the purchase of bonds payable, at prices
greater than the amounts received for them. (C)
"j. Loss incurred in acquiring capital stock, common or preferred (when
stock is to be canceled, and not resold) at higher prices than the
original selling prices. (C)
"k. Loss incurred when the reserve for depreciation is insufficient to
cover the difference between the cost of the property disposed of,
and the disposal price. (E - if due solely to improper depreciation,
otherwise C).
"l. Loss incurred as a result of selling treasury stock at a lower
price than cost. (C)
"m. Loss incurred as a result of the voluntary destruction of properties,
such loss measured by the undepreciated cost at the time of destruc­
tion. (C)
"n. Loss of the undepreciated cost of property not covered by insurance,
such property destroyed as a result of fire or other involuntary
causes. (C)
"o. Necessary increases to all valuation reserves (and hence charges
to surplus) as a result of insufficient charges against the profits
of the past fiscal periods. (E)
"p. Pension fund appropriation out of surplus. (E)
"q. Premiums paid on the redemption of bonds outstanding. (C)
"r. Stock dividends paid. (E or C)
"s. Surplus appropriated to write-off discount on capital stock. (E)
"t. The net loss from operations as determined at the close of each
fiscal period. (E)
"u. Write-off of goodwill against surplus. (E)
"v. Worthless securities charged off. (C)" --Kilduff.
18. Criticise: "Total Assets . . . . . . . . $637,185,602.79

SURPLUS ACCOUNT:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit balance as at December 31, 1931</td>
<td>$12,501,109.56</td>
</tr>
<tr>
<td>Additional Federal income taxes and franchise taxes affecting prior years</td>
<td>376,248.14</td>
</tr>
<tr>
<td>Amounts paid in settlement of litigation, and provision for other contingencies</td>
<td>622,695.11</td>
</tr>
<tr>
<td></td>
<td>$13,500,252.81</td>
</tr>
<tr>
<td>Profit for the year ending December 31, 1932, per accompanying statement</td>
<td>660,076.34</td>
</tr>
<tr>
<td></td>
<td>$12,840,176.47</td>
</tr>
<tr>
<td></td>
<td>$650,025,779.26</td>
</tr>
</tbody>
</table>

(From 1932 consolidated balance sheet of Shell Union Oil Corporation)
665. Individual Proprietor's Capital.

666. Individual Partner's Capital.

667. Explanation of Plate 206.

PLATE 206—Balance Sheet Presentation of Networth.

Review Questions

665. Individual Proprietor's Capital.— Obviously, in a single proprietorship there will seldom, if ever, be any documents to be examined in a verification of the account. Although the amount of the networth will have been verified when the assets and the liabilities have been audited, nevertheless, the balance sheet should give an analysis of the changes in the Capital account, unless a separate exhibit of it is rendered.

666. Individual Partner's Capital.— In the case of a partnership, it is clearly necessary for the auditor to secure the original partnership contract and any subsequent agreements made later as supplements, in order that he may properly distribute the final balance of the Profit and Loss account. Moreover, this information is needed to guide the auditor during his analysis and scrutiny of all accounts, of whatever nature, carried with each partner.

If there is no partnership agreement, or if the provisions are not clear or insufficient, the auditor should draw up a memorandum on the following points and have the several partners sign it.

(a) The purpose of the partnership should be clearly outlined. In addition, the duties of each partner in the business should be given. Experience also shows it advisable for the partners to come to some agreement as to whether or not a partner is permitted to engage in outside transactions, and if so in general what. Another point on which a partnership often comes to grief, when there is no understanding on it, is whether or not each partner is required to devote all of his time to the business. If not, the exceptions should be clearly and adequately defined.

(b) As the backbone of a business is the original capital contributions, these must be defined for the several partners, both as to amount and as to kind. Provision in the way of a penalty, if any, should also be made for the failure of one or more partners to contribute as much as was his (their) assignment.

(c) The per cent of profits due to each partner should be definitely stated, for profits are often distributed in ratios far different from those of the respective capital accounts. Naturally, losses are distributed in the same ratio as the profits. If this is not the intention of the partners, definite provision must be made for it.

(d) As the law does not provide for salaries, these must be specified as to amount, when it is to be credited, whether or not interest is to be allowed thereon if undrawn (and if so at what rate), and whether or not these sums are to be considered as expenses of the business before determining the profit or loss.

(e) It is advisable that there be written into the partnership contract some agreement as to the approval of the individual partners' accounts by all of the partners. Very often there is provided in the exhibit, in which the

1See Appendix C, Sec. 14-#17.
### NETWORTH:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>$xx</td>
</tr>
<tr>
<td>Undivided Profits (Exhibit D)</td>
<td>xx</td>
</tr>
</tbody>
</table>

### NETWORTH:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, March 1, 1931</td>
<td>$xx</td>
</tr>
<tr>
<td>Additional Investments (Exhibit A-1)</td>
<td>xx</td>
</tr>
<tr>
<td>Net Profit (Exhibit D)</td>
<td>xx</td>
</tr>
<tr>
<td>Less - Withdrawals (Exhibit A-1)</td>
<td>xx</td>
</tr>
<tr>
<td>Total</td>
<td>$xx</td>
</tr>
</tbody>
</table>

### NETWORTH:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, March 1, 1931</td>
<td>$xx</td>
</tr>
<tr>
<td>Additional Investments (Exhibit A-1)</td>
<td>xx</td>
</tr>
<tr>
<td>Net Profit (Exhibit D)</td>
<td>xx</td>
</tr>
<tr>
<td>Less - Withdrawals (Exhibit A-1)</td>
<td>xx</td>
</tr>
<tr>
<td>J.P. Harper</td>
<td>$xx</td>
</tr>
<tr>
<td>R.M. Wilson</td>
<td>$xx</td>
</tr>
<tr>
<td>Total</td>
<td>$xx</td>
</tr>
</tbody>
</table>

667. **Explanation and Comments.**—In some instances the proprietor, or the partners, may desire to carry the original investment plus subsequent investments of new capital or portions of income added thereto as fixed capital, the remainder being known as Undivided Profits.

Where this plan is adopted, it is generally agreed to be appropriate to show in the Profit and Loss Statement the balances at the beginning, together with the withdrawals during the period. The balance sheet presentation would then assume the form illustrated in section (a).

In other businesses no such distinction is desired; hence the final profit and loss figure should be carried to an exhibit giving an analysis of the changes in the proprietor’s or the partners’ account(s). In some few cases the summary thereof is also carried in the balance sheet, somewhat as shown in section (b). Of course, if desired, the capital of a partnership can be divided to show the separate interests of the respective partners as shown in section (c).
auditor sets forth the details of the changes in the several partnership capital accounts, spaces for the signatures of the partners. Said signatures signify acceptance of the respective interests of the partners in the business as of the close of the period stated.

(f) Some mention should be made as to whether or not interest is to be allowed on loans and/or charged on withdrawals. If so, the rate and the method of computing the time should be specified.

(g) Interest on capital, if any, should be provided for in detail as to rate and method of computing the time.

(h) If life insurance is to be carried on one or more partners for the benefit of the firm, there must be stated; (1) how the premiums are to be paid; (2) what disposition is to be made of the proceeds if collected; and (3) what disposition is to be made of the policy, if it is in force when the partnership terminates.

(i) If withdrawals are permitted, provision should always be made as to the manner and amount, including any penalties for excesses thereof.

(j) As it is not often that the profit sharing ratio is the same as the capital ratio, the partners should decide whether or not final profits and losses automatically increase or decrease the respective capital accounts, or are to be treated as loans payable or receivable as the case may be.

(k) The partnership contract must be clear as to the procedure to be followed when a partner dies or withdraws. Are the books to be closed at once or are they to be allowed to remain open to the end of the month, or even to the close of the fiscal period? How are profits to be shared in case the books are allowed to run to the end of the regular fiscal period?

(l) If the partnership may be dissolved for reasons other than those provided for in law, these must be stated in detail.

(m) As stated in the early chapters of this text, provision should be made for an audit, and for the method of selecting the auditor.

(n) Provision should be made for the selection of an arbitrator in matters of dispute that cannot be settled internally.

(o) A section should be devoted to stating the method for paying off the capital interest, etc., of a partner who has died or withdrawn.

(p) The exact method for ascertaining the goodwill at any time, if at all, should be given.

567. See Plate 206.

REVIEW QUESTIONS

1. What is your opinion of the following?

"Mr. Malitz: In this same matter of setup, a client consistently treats as a receivable an item of $100,000 withdrawn from the partnership. The net worth of the partnership is $400,000. In showing debts due from employees, partners and salesmen, the accountant maintained that this should not be treated as a receivable but as a deduction from the net worth. This accountant was satisfied that the withdrawal was not spent by the members of the partnership but was used for the purpose of investing in certain assets. The client permitted the accountant to segregate that amount from the employees and salesmen's account, and the accountant said that it did not matter because the bankers would treat that as a deduction anyway, from the net worth."
1. (Continuation) "That may have been so, but the accountant did not have to make matters worse by presenting it that way. Would the bankers have treated it so?

"Mr. Gray: We would not give very much consideration to accounts due from employees and officers as far as the current position is concerned, but it seems to me that the accountant, knowing that $100,000, or twenty-five per cent of the capital had actually been withdrawn from the business, should not allow it to be included in the assets in any way."--"Relations Between Accountants and Bankers", N.Y.S.S. of C.P.A., Nov. 1931, p.45.

2. The Walker Export Co. had made a shipment of goods ($12,689.15 sales price, $9,834.09 cost) to a new customer on the east coast of Africa against which a sight draft has been drawn, but as yet (2 months later) no report has been received from the banks relative to it. How should the transaction be handled?

3. What are some of the legal tests for determining whether or not a business is a partnership?

4. How would you go about valuing the following assets of the Westchester Mills (R.I.) Inc.?

(a) A piece of rental property in Pawtucket, R.I. taken in settlement of an old debt of a customer amounting to $75,312.81.

(b) Common stock of the Warren Corporation representing a 45% interest in this close corporation.

5. What information does the auditor need to abstract from a partnership agreement?

6. In the absence of any agreement is interest to be allowed on partner's capital?

7. How should the auditor, in liquidating a partnership, protect himself from overpaying one partner at the expense of another?

8. Where on the balance sheet should loans payable to partners be placed?

9. The following is a section of the voucher register of the B Co. wherein the discount is deducted before the entry is made.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1/8</td>
<td>1718</td>
<td>Barker &amp; Smith</td>
<td>1940.00</td>
<td>60.00</td>
<td>1940.00</td>
<td>980.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1719</td>
<td>Joyce Bros.</td>
<td>980.00</td>
<td>20.00</td>
<td>980.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Price the following inventory:

<table>
<thead>
<tr>
<th>Invoice price each</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market</td>
<td>9.50</td>
<td>9.97</td>
</tr>
</tbody>
</table>

10. In the absence of any agreement are salaries payable, say at a reasonable amount, to the partners?

11. In the absence of any agreement are drawings allowed?

12. In the absence of any agreement is interest on drawings (if allowed) to be charged?

13. In the absence of any agreement how are profits and losses divided, assuming that the capital accounts are not equal?

14. What is your opinion of the validity of the following procedure? Why?

"Stockholders of the American Superpower Corporation will vote at the annual meeting April 15 on a proposal to reduce the stated value of $100 preference stock to $1 a share from $100. This move, which will result in the transfer of approximately $23,235,000 from capital to surplus, was proposed in order that the company might continue the payment of preferred dividends without conflict with incorporation requirements regarding impairment of capital."
CHAPTER 43

THE VERIFICATION OF CAPITAL STOCK

668. Introductory Remarks.

669. The verification of the Account.

670. Explanation of Plate 207.

671. Schedules.

PLATE 207--A Charter.

672. Explanation of Plate 206.

PLATE 206--A Schedule on Capital Stock (1st type).

673. Explanation of Plate 209.

PLATE 209--A Schedule on Capital Stock (2nd type).

674. Explanation of Plate 210.

PLATE 210--A Schedule on Capital Stock (3rd type).

675. Explanation of Plate 211.

PLATE 211--A Confirmation Letter from a Registrar.

676. Watered Stock.

PLATE 212--Sundry Resolutions on Plant Property.

677. Explanation of Plate 213.

PLATE 213--A Form of Installment Ledger.

678. Treasury Stock.

679. Additional Assessments Above Par.

679. Treasury Stock.

680. Stock Taxes.

681. Accumulated Dividends.

682. The State Statutes.


684. Non-Par Value Stock.

685. The Balance Sheet Presentation

686. Installments.

687. Explanation of Plate 215.

PLATE 215--A Form of Installment Ledger.

688. Explanation of Plate 214.

PLATE 214--A Form of installment Receipt.

689. Stock Subscriptions.

690. Explanation of Plate 215.

PLATE 215--A Form of Individual Subscription Record.

691. Explanation of Plate 216.

PLATE 216--A Form of Subscription Journal.

692. Capital Stock Certificates.

693. The Stock Certificate Book.

694. Explanation of Plate 217.

PLATE 217--A Stub of a Stock Certificate Book (1st type).

695. Explanation of Plate 218.

PLATE 218--A Stub of a Stock Certificate Book (2nd type).

696. Explanation of Plate 219.

PLATE 219--A Fraction of a Share of Stock.

697. Explanation of Plate 220.

PLATE 220--Special stock Certificates.

698. Stock Transfers.

699. Explanation of Plate 221.

PLATE 221--Assignment Form.

700. Explanation of Plate 222.

PLATE 222--An Irrevocable Stock Power of Attorney.

701. Restrictions on Transfers.

702. The Transfer Journal.

703. Explanation of Plate 223.

PLATE 223--A Form of Stock Transfer Journal. (1st type)

704. Explanation of Plate 224.

PLATE 224--Forms of Stock Transfer Journals. (2nd type)

705. The Transfer Agent.

706. The Registrar.

707. The Capital Stock Ledger.

708. Explanation of Plate 225.

PLATE 225--Forms of Capital Stock Ledgers.

709. Explanation of Plate 226.

PLATE 226--Forms of Capital Stock Ledgers.

710. Explanation of Plate 227.

PLATE 227--A Form of Capital Stock Journal for Original Issues.
711. The Dividend Records.
712. Explanation of Plate 226.
   PLATE 226—A Form of Dividend Book.
713. Explanation of Plate 229.
   PLATE 229—Dividend Announcements.
714. Explanation of Plate 230.
   PLATE 230—A Form of Scrip Dividend.
715. An Audit Program.
716. Explanation of Plate 231.
   PLATE 231—A Form of Warrant.
717. Explanation of Plate 232.
   PLATE 232—A Form of Stock Right.
718. Explanation of Plate 233.

Review Questions.

668. Introductory Remarks.—In addition to a discussion of the auditing procedure necessary to verify the capital stock accounts, this chapter will present material on collateral features, especially on some of the special books of record often used in connection with the subscribing, calling of installments, issuing, transferring, etc. of capital stock.

669. The Verification of the Account.—If the present engagement is the first audit of the corporation to be made by certified public accountants, the SENIOR auditor should reserve for himself the task of examining the charter (Plate 201) or certificate of incorporation, the by-laws of the company, the various authorizations of additional issue or reduction (if any) granted under seal by the Secretary of State, the minutes of the Board of Directors and those of the stockholders, the corporation laws of the state under which the company is incorporated,1 and all other pertinent records. This procedure will inform the auditor of the limitations imposed by the state, the by-laws and/or others on the issuance of the shares, etc.; it will put the auditor in a position to know when ultra vires acts have been committed; it will give him the classes of shares authorized, their number, and par value, if any; it will show him the subscription price set by the directors to be paid in and the method and time of paying it; it will give him the necessary information on any special purchases of property for stock; it will show him what ratios, if any, must be maintained between current assets and current liabilities before common dividends may be declared; it will inform him as to the rights of stockholders who have forfeited their stock subscriptions; it will inform him as to the proper legal treatment of no par value stock, paid-in capital surplus, stockholders' liability for stock discount, legality of acquisition of treasury stock, treatment of appraisal surplus, etc.; and in diverse other ways help him to complete a satisfactory authentic verification of the entries in the capital stock and allied accounts.

In brief, under the conditions named, the capital stock accounts should be analyzed from the date of incorporation to the date of the audit, or, where this recommendation is obviously impractical, for a reasonable period of time. As Bell states, "It is sometimes necessary to make this

1. The necessity for becoming acquainted with the Corporation Statutes of the state of incorporation should be clear to the reader after reviewing Section 662.
investigation of the records of the original stock issues regardless of the time intervening between such issues and the audit of the accounts. However, when a corporation has been established for some years, there is usually no necessity of undertaking an extensive investigation along this line, other than to ascertain the authorized stock issue, unless there is some doubt as to the accuracy of the capital stock as stated on the books. 1

Having audited all of the entries in the account, the auditor can then accept the balance. This must be further verified by independent confirmation with the registrar and/or transfer agent, if any. If only a registrar has been employed, the auditor, in addition to getting a certificate from it, may also take a list of the open balances in the capital stock ledger, if any, and/or of the open stubs in the stock certificate book for comparison with the balance(s) of the capital stock account(s). If neither a registrar nor a transfer agent exists, the auditor MUST see that the stock ledger and/or certificate book are in agreement with the capital stock controlling account (or accounts). And, in a detailed audit, a test of the stock transfers must also be included in the audit program.

670. See Plate 207.

671. Schedules. — In certain rare instances it may be necessary or advisable for the auditor to prepare from the stock certificate book and/or stock ledger a list of the names of the stockholders with their stock holdings. In the case of a closed corporation, it is common for the auditor to list the chief stockholders, and to group the others together as in Plate 206. In most instances, however, again assuming neither transfer agent nor registrar, it is sufficient for the auditor to take off an adding machine tape of the outstanding shares. If the tape is short, it is sometimes cut off into strips and pasted on to one or more work sheets in substantiation of the work done. Otherwise the tape is destroyed; it being sufficient in all cases for the auditor to note on the analysis sheet what was done.

If there have been changes in the stock accounts during the year, the schedule should be drawn up along the lines of Plate 210, except that in this instance there were no changes during the year. The schedule should show the number of shares and the value thereof at the opening date of the audit as per the general ledger and as per the auditor's working papers on the last audit, if any. If there are any increases in the shares issued, the date of issuance, the number of shares, the amount and nature of the consideration received, etc., should all be shown and tied-in to other schedules, where possible, by means of cross index letters (see Plate 209.) If the additional shares had to be authorized by the Secretary of State, this fact should be indicated by a note to the effect that the Secretary's Certificate was examined, and index letters should refer to the authorization per the minutes of the stockholders, etc. Likewise, any decrease in the shares should be fully described and indexed to substantiating documents, and allied schedules. Finally, the balance thus secured must be verified, such as against the Registrar's Certificate (Plate 211) and/or against the balances in the stock ledger, etc.

WHEREAS

did on the ___ day of ___, 193_, file with the Secretary of State a written Declaration, signed by themselves, setting forth:

FIRST: That their names and residences are as above given.

SECOND: That the name of the proposed corporation is ____________

THIRD: That the principal place of business is ____________

FOURTH: That the general nature of the business which it is proposed to do is ____________

FIFTH: That the amount of the capital stock is ____________ dollars, payable ____________

SIXTH: That the number of shares into which the capital stock is divided is ____________ of the par value of ____________ Dollars.

SEVENTH: That, after due notice, a meeting of the subscribers was held on the ___ day of ___, 193_, at which a majority of all stock in value being present in person or by proxy, the following were elected directors:

EIGHTH: That subsequently there was elected as President, ____________; as Vice President, ____________; as Secretary, ____________; as Treasurer, ____________

NINTH: That all requirements of Chapter L, Article I, of the civil Code of South Carolina, 1922, and all amendments thereto have been duly and fully complied with, 50 per cent. of the aggregate amount of the capital stock having been subscribed by bona fide subscribers, 20 per cent. of the capital stock subscribed having been paid to the Treasurer, and three days' public notice of the intention of file this Declaration with the Secretary of State having been given in ____________ a newspaper published in the County of ____________.

NOW, THEREFORE, I, W.P. BLACKWELL, Secretary of State, by virtue of the authority in me vested by the aforesaid Code and Acts amendatory thereto, do hereby certify that the said Company has been fully organized according to the laws of South Carolina, under the name and for the purposes indicated in their written declaration, and that they are fully authorized to commence business under their charter; and I do hereby direct that a copy of this certificate be filed and recorded in the office of the Register of Mesne Conveyance or Clerk of Court in each county where such Corporation shall have a business office.

GIVEN under my hand and seal of the State, at Columbia, this ___ day of ___, in the year of our Lord one thousand nine hundred and ______ and in the one hundred and fifty ______ year of the Independence of the United States of America.

Secretary of State.

670. Explanation and Comments.—On a first audit, the auditor should ask for the company's charter if it is not to be found in its customary place in the front of the minute book. Thus, the auditor assures himself that the business really is incorporated. Furthermore, he can then ascertain from this authoritative source (1) the powers of the corporation, and (2) the classes, number of shares, and par value (if any) of the authorized capital stock, assuming that no further authorizations have been granted by the Secretary of State.
Watered Stock.--As has been stated elsewhere, whenever properties, or services have been paid for with capital stock, the directors should authorize in their minutes (Plate 212) the purchases and determine the values at which they are to be brought onto the books of account. The auditor’s duty is merely to make a full disclosure of the "surface" facts and to see that there is no fraud involved and that the company's accountant has made the proper entries to express the directors' intention. Thus, although the general rule is that an auditor must not certify to something which he believes to be incorrect, nevertheless, auditing procedure in this particular instance has not yet reached the point where it excels the law—which, in the absence of fraud, does not require an auditor to attach the directors' opinion of values given and received. Of course, if he is making an examination for someone other than the corporation, the auditor may be asked to investigate and report upon this point, or if not asked, he may do so of his own initiative, recognizing that this is the sort of information which his employer desires. But on an ordinary engagement, the auditor is confined in his duties, seeing that he is neither an appraiser nor compelled or expected by law to challenge the good faith of the directors, to stating on the balance sheet and in the report the basis of the valuation. Watered stock often comes into being in order to circumvent the law of the state which prohibits the sale of par value stock at a discount. As it is often difficult for a new enterprise to sell its stock at par, it may resort to issuing fully paid stock in payment of services or property to an amount in excess of the real values involved, the prearranged agreement being that the stockholders will donate, or sell back to the corporation at a low price, a certain amount of this stock. As treasury stock may be legally sold for whatever it will bring, the corporation is then in a position to sell stock (i.e. the treasury stock) at a discount, and thereby secure the necessary working capital. In some few instances, it should be stated, the sales price of the property may be bona-fide and the donation also.

The term Watered Stock is said to have arisen from the practice of farmers giving cattle salt in their feed to make them thirsty, and then waterering them just before reaching the butcher's market where the cattle were sold by weight.

Treasury Stock.--Treasury stock is sometimes classified with unissued stock, but this is a mistake as there are important differences

1. "Such I take it 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, and he must take reasonable care and skill before he believes that what he certifies is true."—by Lindley, L.J.—in re London & General Bank, 2 Chanery 166 (1895)
2. —See Section 682.
A SCHEDULE ON CAPITAL STOCK (1st type) PLATE 208

The Holliwell Lumber Yards, Inc.
Capital Stock
Audit for Year Ended Dec.31, 1930

<table>
<thead>
<tr>
<th>Credit</th>
<th>#</th>
<th>HH-1</th>
<th>200000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>To B/S</td>
</tr>
</tbody>
</table>

Balance per G/L 12-31-30

<table>
<thead>
<tr>
<th>Certificate Numbers</th>
<th>Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>J.K. Holliwell</td>
<td>510</td>
</tr>
<tr>
<td>Wm. Holliwell</td>
<td>410</td>
</tr>
<tr>
<td>R. Hardy</td>
<td>100</td>
</tr>
<tr>
<td>N. Hardy</td>
<td>50</td>
</tr>
<tr>
<td>G. Watt</td>
<td>50</td>
</tr>
<tr>
<td>The Holliwell Lumber Yards, Inc. (Treasury stock)</td>
<td>28</td>
</tr>
<tr>
<td>Sundry persons (Less than 25 shares each)</td>
<td>832</td>
</tr>
</tbody>
</table>

AUDIT PROCEDURE

Checked all of the entries in the Transfer Journal to the Stock Ledger, and accounted for the cancelled shares (pasted to the stubs).

Took a trial balance of the Stock Ledger and also of the open stubs in the Certificate Book. They agreed with the above, i.e. 2000 shares.

Examined the treasury stock on 2-7-31. Also, see Schedule K.

## See HH-1 for a detailed analysis of the various considerations received for this stock. As shown therein (HH-1), special items were checked to the directors' minutes. The charter showed an authorized issue of 2000 shares at $100 per value each.

672. Explanation and Comments.--Ordinarily, all of the audit procedure outlined in this plate would be taken only in the case of a close corporation; i.e., one where the transfers are few. The usual procedure is to get a certificate from the Registrar, and possibly from the Transfer Agent, when they have been employed, as to the amount of stock authorized, and issued.

When neither a Registrar nor a Transfer Agent has been employed, a tape list of the balances of the Stock Ledger, and/or one of the open stubs in the Certificate Book, is necessary. A few transfers should also be checked in order to see that the stock records appear to be bona fide and in order.

- If there is a registrar but no transfer agent, the certificate of the registrar is sufficient. Ordinarily, however, an adding machine tape list of the certificate book and/or ledger will also be taken if the task is a light one.
A SCHEDULE ON CAPITAL STOCK (2d type) PLATE 209

The Harriman Soap Works, Inc.
Capital Stock
December 31, 1930

Authorized 20000 shares at $100 par each

Credit
Capital stock - Issued and Outstanding 12/31/30 1320000.00

Authorized issue 20000 Sh. at $100 each

DEDUCT- Capital stock - Unissued 6800 Sh.

Capital stock issued and outstanding 12-31-30

AUDIT PROCEDURE

The amount, etc. of the authorized stock was checked (1) to the charter which has been abstracted on sheet #15 and (2) against the Registrar's Certificate AA-1.

The final balance was checked to the Registrar's Certificate AA-1.

The transfer agent is the Mahante Trust Co. of Philadelphia.

(READER'S NOTE: Schedule AA-2 gives an analysis of the Capital Stock - Unissued account, showing the various considerations received for the stock.)

673. Explanation and Comments.--As stated in the text, when a registrar exists, the auditor should get its certificate on the amount of capital authorized, and issued. Naturally, in so far as it goes, this is the auditor's best proof of the capital stock accounts.

If there is no transfer agent, the auditor may in addition undertake to trace through a few transfers and/or take off a tape list of the share balances in the stock ledgers and/or the number of shares on the open stubs in the stock certificate books. Ordinarily, however, this would not be done in a balance sheet audit unless the task was a small one. If there is a transfer agent, the records, of course, will not be on hand for the auditor to test. Indeed, there is then no need of any test.

It will be recalled from the text that leading Stock Exchanges require that the corporations listed on it must employ both a transfer agent and a registrar. Each of these must be distinct from the other. And they must be located within a certain area of the Exchange (the borough of Manhattan in the case of the N.Y. Stock Exchange) so as to be within easy reach.

Notice that the balance of $1,320,000 is the difference between two accounts.

See also plate 211, A Confirmation Letter from a Registrar.
A SCHEDULE ON CAPITAL STOCK (3d type) PLATE 210

Walker & Burroughs, Inc.
Common Capital Stock
B/S Audit for the Five Years Ended Dec. 31, 1930

Authorized $1,000,000 Par $50

<table>
<thead>
<tr>
<th>Date/Description</th>
<th>Number of Shares</th>
<th>Par Value</th>
<th>From Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/30</td>
<td>10200 shares</td>
<td>$50</td>
<td>$50,000</td>
</tr>
<tr>
<td>Q3-1</td>
<td>5000 shares</td>
<td>$50</td>
<td>$250,000</td>
</tr>
<tr>
<td>Q3-5</td>
<td>5000 shares</td>
<td>$50</td>
<td>$250,000</td>
</tr>
<tr>
<td>Q3-7</td>
<td>200 shares</td>
<td>$50</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

Name  | Stock Certificate Numbers | Shares per Open Stubs | Shares per Ledger
John R. Rose | 1 | 2000 | 6058
William B. Small | 2 | 1000 | 1150
John R. Rose, Jr. | 3 | 500 | 500
Charles Dexter | 4 | 100 | 100
Cancelled - Certificates attached | 5 to 160 | |
John R. Rose | 161 | 2051 | See above

OMISSIONS

A. B. Curtis | 688 | 3 | 3
Unissued | 689 to 4000 | |
Total shares outstanding | | 10200 | 10200

AUDIT PROCEDURE

The Company's R.I. charter shows an authorized issue of 20,000 shares of common stock of $50.00 par value each. The above issues were properly authorized by the stockholders and the directors. See QQ schedules indicated above. The cash was traced into the Cash Receipts Book and the stock dividends to the surplus account. The dividends paid during the period 1/1/26 - 12/31/30 checked with the above outstanding shares. The Company has neither a registrar nor a transfer agent. All stock certificate books (4) were examined throughout for certificates issued out of order, but no irregularity was found. Cancelled certificates were seen to be "CANCELLED". They were all pasted to their respective stubs in the Stock Certificate Books. All revenue stamps were attached and cancelled. The balances of the ledger accounts were taken off and reconciled to the open stubs as shown above. About 100 transfers (marked by us in the Transfer Book) were checked throughout; i.e. the Transfer Journal, the Stock Ledger, and the Certificate Book, including the cancelled stock. Everything has checked out satisfactorily.

674. Explanation and Comments.—This is an unusual schedule in that it is only on rare occasions that the list of the stockholders is drawn up on a working paper.

Read the Audit Procedure carefully. Note the exactness with which it describes the various auditing steps taken.
THE DEVONSHIRE TRUST COMPANY
Boston, Massachusetts

Established 1890

Schedule AAI
Capital $11,500,000
Surplus $10,000,000

January 14, 1931

Messrs. Price, Williams & Co.,
718 State Street,
Boston, Massachusetts

Dear Sirs:

Pursuant to the request of The Harriman Soap Works, we take pleasure in advising you that on December 31, 1930 the Capital Stock of said Corporation stood as follows:

Authorized -20,000 shares at $100 par value each $2,000,000 To AA
Issued 13,200 shares 1,320,000
To AA

Cordially yours,

(signed) K.F. Small
K.F. Small

675. Explanation and Comments.--This plate goes with plate 209 being the certificate referred to therein. As has been emphasized, when there is a registrar, its certificate MUST be secured, as it represents the best sort of proof of the accuracy of capital stock accounts in respect to the aspects certified to.
(a) Directors' Resolution Accepting Property Purchased With Capital Stock

Resolved, that this Corporation accept the proposal (dated January 19, 1931) of The Williamson Iron Works to sell its net assets for __ One Million Five Hundred Thousand ___ Dollars ($1,500,000) payable at par in common capital stock of this Corporation, and furthermore be it

Resolved, that the president of this Corporation be and is hereby authorized and directed to execute said proposal on behalf of this Corporation, and to issue full paid and non-assessable common stock of this corporation in satisfaction thereof to the amount of $1,500,000 par value.

(b) Stockholders' Resolution Ratifying Directors' Acceptance of Property Purchased With Capital Stock

Whereas, the Board of Directors of this company has accepted the proposal (dated January 19, 1931) of The Williamson Iron Works ___ to sell its net assets for the sum of One Million Five Hundred Thousand Dollars ___ ($1,500,000.00) payable at par in common capital stock of this company, be it

Resolved that said action of the Board of Directors be and is hereby ratified and approved.

(c) Directors' Certificate of Appraisal

Whereas, The Williamson Iron Works of Pawtucket, R.I. has in writing made an offer to The Chelsea Iron Works, a corporation organized under the laws of the State of Connecticut, to sell to said Chelsea Iron Works the property described in Exhibit A hereto attached, (not shown here) and also to sell to said Chelsea Iron Works the goodwill and other intangible assets of said company.

Now, therefore, we the Board of Directors of said Chelsea Iron Works do hereby certify that we have made a careful valuation of said property and other intangible assets described in Exhibit A, and have found the same to be of a fair value of One Million Five Hundred Thousand Dollars. ($1,500,000)

James U. Reinhardt
chairman

William Russell
Russell A. Brokendish
Samuel M. Thomas

677. Explanation and Comments.—Purchases of property for stock should be verified by the auditor against authorizations in the minute book. Furthermore, the auditor should insist that the directors break down and value in proper units any properties which have been purchased in the aggregate for a lump sum.
between the two. For example, if need be, treasury stock can always be issued as a bonus, or for whatever it will bring, whereas unissued stock is not available (because not wanted) for this purpose, or at this price. In some instances this very difference is of paramount importance to the life and success of the corporation. Treasury stock is of course stock that has been issued for full value and has come into the treasury of the issuing corporation either as a donation, or as a purchase, or in settlement of a debt, etc.

Treasury stock remains as such until it is either sold or retired. This latter act requires the formal sanction of the State, and should always be verified by the auditor by examining the State documents on hand which permit the reduction. In some states corporations are not permitted to purchase their own stock unless there is an equivalent of surplus, (Often limited to Earned Surplus) or unless it is taken in settlement of a debt, or received as a donation. The auditor should, of course, post himself on this aspect of the law.

In some instances this very difference is of paramount importance to the life and success of the corporation. Treasury stock is of course stock that has been issued for full value and has come into the treasury of the issuing corporation either as a donation, or as a purchase, or in settlement of a debt, etc.

This latter act requires the formal sanction of the State, and should always be verified by the auditor by examining the State documents on hand which permit the reduction. In some states corporations are not permitted to purchase their own stock unless there is an equivalent of surplus, (Often limited to Earned Surplus) or unless it is taken in settlement of a debt, or received as a donation. The auditor should, of course, post himself on this aspect of the law.

In such states, the auditor may either add together the surplus accounts (available for dividends) and then deduct the treasury stock at cost from them, or handle the treasury stock as a deduction at par (or average value) from the capital stock account, provided a note be attached to the surplus available for dividends stating the amount legally unavailable by reason of the treasury stock purchased.

If a very small amount of treasury stock has been purchased for resale, it may be treated on the balance sheet as if it were a current asset, and valued at cost or market, whichever is the lower. If, however, the amount is large, it MUST be deducted at par from the outstanding stock in the networth section of the balance sheet.

On some occasions the client will be carrying the account along at cost as a permanent investment. If so, the auditor's working sheet adjustment of the difference between cost and par value should be charged or credited to capital surplus. Some few auditors, however, favor carrying this difference on the balance sheet as an OTHER ASSET, (when cost is in excess of par, or book, value) or as Contingent Profit on Treasury Stock (when par, or book, value is in excess of cost), a capital surplus account.

When the treasury stock has been purchased and virtually retired, the account should be carried at par, the excess of cost over par (or book value) being charged to capital surplus; or if par (or book value) is greater than cost the excess may be credited to earned surplus, if very small, otherwise to capital surplus.

When par value stock is received as a donation, it should be carried at par, the offsetting credit being to some such account as Contingent Profit on Donated Treasury Stock. This account represents unrealized capital surplus and is, therefore, neither a part of profit and loss income nor of surplus available for dividends. Of course, theoretically, there may be very substantial reasons for treating the above credit (or the final credit when the proceeds from the resale have been realized) to

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1. See ADDENDUM
2. This is entirely incorrect procedure.
3. This is satisfactory procedure.
4. If a premium (or a discount) account on this stock is still open on the books, it should be charged (credited) with a proportional amount.
5. Some state corporation laws do make it available.
the inflated property accounts (if any) which were bought by the client from the donor stock-holder, but from a practical aspect an auditor has no right (and usually no definite facts) whatever to do so of his own initiative. As the stock is sold, the proceeds should be credited to Surplus from Donated Capital Stock, and the par value of the stock should be debited to Contingent Profit on Donated Treasury Stock and credited to Donated Treasury Stock.

In the case of no-par-value stock, no entry (unless at the average value in the capital stock account) needs to be made until such time as the stock is sold. In the meantime, careful memoranda will be sufficient.

When Treasury Stock has been donated, the proceeds thereof when sold are capital surplus. Likewise, when capital stock is purchased or acquired for permanent or formal retirement, the credit, if any, resulting from the excess of par (book value) over cost should also be to capital surplus, and vice-versa when the cost exceeds the par (book) value. On the other hand, if treasury stock has been purchased for resale, the profit, if any, which is made should, according to most auditors, be shown in the profit and loss statement as Profit and Loss on Sales of Securities, an 'earned surplus item. There is no difference between this type of transaction and one involving the sale and purchase of another corporation's securities. (See ADDENDUM)

In verifying the existence and location of certificates for treasury stock, the same auditing procedure should be taken as that used in verifying any other securities that are owned. They should be seen to be real treasury certificates. The consideration, if any, which was given for them must be ascertained, and the method of recording the transactions in the accounts should be checked. The stock should be in the name of the company, or else endorsed specifically or in blank, as in the case of directors' qualifying shares. In the balance sheet presentation, the number of shares on hand should be disclosed.

679. Additional Assessments Above Par.--Under contingent liabilities, it was pointed out that even fully paid for stock is subject to additional assessments under the laws of a few states, and invariably so, until recently, in the case of national bank stock. At this point, it is purposed to explain that if the assessment is made and received, the sum constitutes additional capital. Being such, it must be credited to CAPITAL surplus rather than to earned surplus, for otherwise future dividends may be paid out of this very money. This is the conclusion reached by sound reasoning, but unfortunately many state statutes permit the corporation to pay this very type of surplus back to the stockholders even in the disguise of dividends.

1. "An exception would doubtless be conceded in a case where preferred stock has been sold at a discount and such discount was charged against earned surplus. Any discount realized on the reacquisition of such stock represents a recovery of the previous charge to earned surplus and to that extent is a proper credit thereto. In those cases where preferred stock is retired at a stipulated premium, the premium is in the nature of a supplemental dividend or compensation to the preferred stockholder for the use of his capital, and in such cases would be properly charged to earned surplus as in the case of ordinary dividends." W.A. Staub, J.of A., Jan. 1932.

2. The writer agrees that there is no difference, but regards the Profit and Loss on Sales of Securities Account as realized Capital Surplus.
of genuine earned dividends. When and if in the future it is desirable to return such unneeded assessments, the directors have a clear moral duty to state on the dividend checks the true nature of the payment. The auditor should see that this is done.

If an assessment is made because of an existing deficit, it appears that it is improper to offset the one account against the other in published balance sheets. But if the capital stock is reduced with permission of the State, this separation is not required AFTER the first new balance sheet has made a full disclosure.

680. Stamp Taxes.—The auditor must be familiar with the federal and/or state law, if any, regarding stamp taxes on original issues and/or transfers. The law usually requires the stamps to be attached to the stock books rather than to the certificates issued. As the penalties for failure to comply with the stamp tax law may be considerable, the auditor can serve his client by examining the stock books for failure to comply with the law.

681. Accumulated Dividends.—Although accumulated dividends are not a liability, nevertheless, it is reiterated that the amount thereof must be shown on the balance sheet, or else essential information is withheld from the holders and prospective purchasers of junior issues, and of the very issue itself.

Sometimes a portion of the free surplus to the amount of the accumulated dividend, assuming that enough exists, is set up under a suitable caption like, Surplus Applicable to Accumulated Preferred Dividends. The most common method, however, is to make a note of the arrears either in the preferred stock division of the networth section of the balance sheet, or in an appendage at the bottom of the balance sheet.

682. The State Statutes. 1—The importance of the auditor's becoming acquainted with the corporation law of the state in which the company is incorporated cannot be over emphasized. In proof of this statement, the following provisions of the Ohio law are given.

8623-22. Payment for Shares.—Except as hereinafter in this act provided, in the case of a consolidation of corporation, shares shall be issued only for money, or for other property, real or personal, tangible or intangible, actually conveyed or transferred to the corporation for its use and lawful purposes, or in its possession as surplus, or for labor or services actually rendered to the corporation.

Every person who subscribes for par value shares or to whom such shares are issued, except as a share dividend, shall be obligated to pay the corporation therefor, in money or such other property or labor or services, not less than the full par value thereof, except as hereinabove in this act provided.

Every person who shall subscribe for shares without par value, or to whom such shares are to be issued except as a share dividend, shall be

1. Under the leadership of the class instructor, rewrite these statutes in the form you think they ought to be.
obligated to pay the corporation therefor, in money or such other property or labor or services, such amount of consideration for each share as may have been determined as hereinbefore in this act provided.

Promissory notes, drafts or obligations, of a subscriber or purchaser, shall not be accepted in payment for shares, nor shall shares be issued for future services.

8623-23. Paid-in surplus.—If any part of the consideration received for shares without par value is to be treated as paid-in surplus, the incorporators, shareholders or directors, as the case may be, shall, at the time of fixing the consideration for which shares are to be issued, fix and specify the amount of the consideration to be allotted to stated capital and paid-in surplus respectively.

8623-25. Valuation.—Any determination of the fair value to a corporation of considerations other than cash accepted or agreed to be accepted in payment for shares shall be conclusive in any suit, action or proceeding in which it is claimed that the fair value to the corporation of such considerations other than cash is or was less than the amount of consideration for which the shares were authorized to be issued, if such determination was entered on the books of account of the corporation, and if such determination

(a) was made by the incorporators by a statement in the articles or in the acceptance by them of any subscription; or
(b) was made by the board of directors; or
(c) was made or approved by the vote of the holders of a majority of the outstanding shares of the class of shares to be issued and of all shares junior thereto. For the purposes of this paragraph, the holders of record of the shares belonging to the same class as the shares to be issued, and the holders of record of all shares junior to the shares to be issued, shall be entitled to vote regardless of any limitations or restrictions on the voting power of any such class of shares, unless the party asserting such claim shall affirmatively prove by clear and convincing evidence, and otherwise than proving the difference between the value of such considerations and the amount so determined, that such determination of value was knowingly and intentionally made and fixed at an amount known to the parties making the same to be greater than the fair value of such consideration to the corporation.

In every suit, action or proceeding, the determination of the amount of consideration for which shares may be issued and the making of an agreement to issue shares for considerations other than money, or the issuance of shares for such considerations, shall be held to be a determination that such considerations have a fair value to the corporation equal to the amount of consideration for which such shares were authorized to be issued.

8623-29. Cost of organization.—A corporation may pay as cost of organization the reasonable charges and expenses incident thereto and may also pay or allow reasonable compensation for the sale or underwriting, at the time of organization or thereafter, of its shares and securities or any part thereof, but all amounts so paid out or allowed or any balance thereof not previously charged off shall be stated on the books of the corporation and on every balance sheet prepared therefrom until the whole thereof has been written off.

8623-28. Payment of dividends.—No corporation shall pay dividends:

(1) in cash or property, except from the surplus of the aggregate
of its assets over the aggregate of its liabilities, plus stated capital, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets;

(2) in shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, plus stated capital.

In computing the aggregate of the assets of the corporation, the directors shall determine and make proper allowance for depreciation and depletion sustained and losses of every character. Deferred assets and prepaid expenses, excepting organization expense and financing charges, shall be written off at least annually in proportion to their use as may be determined by the board of directors. Organization expense and financing charges may be written off in the discretion of the board of directors.

Cash dividends shall not be paid out of surplus due to or arising from (a) unrealized appreciation in value of or a revaluation of fixed assets, or (b) any profit on treasury shares before resale, or (c) any unrealized profits due to increase in valuation of inventories before sale, or (d) the unaccrued portion of unrealized profits on notes, bonds, or obligations for the payment of money purchased or acquired at a discount, unless such notes, bonds or obligations are readily marketable, in which case they may be taken at their actual market value, or (e) the unaccrued or unearned portion of any unrealized profit in any form whatsoever, whether in the form of notes, bonds, obligations for the payment of money, installment sales, credits, or otherwise.

When the directors so determine, dividends may be paid in shares at the par value thereof, or, in the case of shares without par value, at a value fixed by the board of directors, provided that no dividend payable in the shares of any class shall be paid to shareholders of another class unless the articles otherwise provide or such payment is authorized by the affirmative vote of the holders of a majority of the shares of the class in which payment is to be made.

Amounts of surplus arising from an unrealized appreciation of or a revaluation of fixed assets shall be shown on the books of a corporation separate from surplus profits and capital or paid-in surplus.

The excess of consideration paid in by shareholders for shares having par value over the par value thereof, or for shares having no par value over the amount allotted to stated capital with respect thereto, shall be shown on the books of the corporation as a separate item designed "paid-in surplus" or "capital surplus." In case all or any part of any cash dividend is paid out of such paid-in or capital surplus, the stockholders shall, at the time of payment, be notified of that fact.

No distribution of capital shall be designated as or made to appear to be a dividend.

A corporation which owns or is to own wasting assets intended for sale in the ordinary course of business, such as coal or ore mines or oil or gas wells, or a corporation which is to hold property having a limited life, such as a lease for a term of years, or patents, may include in its articles a provision that the depletion of such assets by sale or lapse of time need not be deducted in the computation of surplus available for dividends, and a corporation which so provides in its articles may pay for dividends without deduction of such depletion, subject, however, to the rights of shareholders of different classes.
No dividend shall be paid to the holders of any class of shares in violation of the rights of the holders of any other class of shares.

2623-41. When corporation may purchase shares. – A corporation may purchase shares of any class issued by it:
(a) When the articles authorize the redemption of such shares and do not prohibit such purchase; or
(b) To collect or compromise a debt, claim or controversy in good faith; or
(c) To the extent of the surplus available for cash dividends when authorized by the affirmative vote of the holders of two-thirds of each class of shares outstanding, regardless of limitations or restrictions on the voting power of any such class, or by such other vote as may be prescribed in the articles, or by the board of directors when authorized by the articles, but no such purchase shall be made so as to favor any shareholder over any other; or
(d) For the purpose of resale or allotment to employees under the provisions of section 36 of this Act; or
(e) From an employee who has purchased such shares from the corporation under an agreement reserving to the corporation the right to repurchase or obligating it to repurchase.

Whenever a corporation shall acquire in any way any of its own shares, they shall be carried on its books as treasury shares until disposed of by sale or reduction of stated capital.

A corporation shall not purchase its own shares except as provided in this section, nor unless after such purchase there shall remain in excess of assets over all the debts and liabilities of the corporation, plus stated capital after deducting the amount of stated capital in respect of the shares to be purchased.

2623-124. Unlawful dividends and withdrawals of capital. – The directors of a corporation shall not pay dividends or withdraw or distribute any part of its stated capital except as provided in this Act.

In case of any wilful or negligent violations of the provisions of this section the directors under whose administration the same shall have happened, except those who may have caused their dissent therefrom to be entered upon the minutes of such directors at the time or who were not present when such action was taken, shall be jointly and severally liable to the corporation at any time within two years after each such violation for the full amount of any loss sustained by such corporation by reason of any such dividend, withdrawal or distribution.

A director shall not be held to have been negligent within the meaning of this section, if he relied and acted in good faith upon a balance sheet and profit and loss statement of the corporation and a statement of the computation of the surplus available for dividends represented to him to be correct by the officer of the corporation having charge of or supervision over its accounts, or certified to be correct by a public accountant or firm of public accountants of good reputation and if he caused such balance sheet and statements to be entered on the books of account or record of the corporation.

683. The Provisions of the Capital Stocks. – It is believed that if the reader will review the contents of Plate 16, he will find it easy to see why the auditor must abstract for his permanent file of working papers the provisions of each class of stock. And, having done so the auditor should make use of the information to see that none of the provisions are in default. Moreover, a very much neglected field in
which the information could be used is the balance sheet. Unfortunately, the captions and explanations of the capital stocks in most balance sheets are very meager.\(^1\) As Montgomery points out, "It may require a long explanation to describe dividend and redemption provisions, but the auditor is charged with the duty of declining to certify a balance sheet unless it is an accurate picture."\(^2\) In short, all inherent rights denied the preferred stock should be indicated, together with any special preferences granted.

684. No-Par Value Stock.---(a) Introduction.---Although the auditing procedure in the case of no-par value stock is essentially the same as that for par value stock, nevertheless, it will assuredly not be amiss to give a brief discussion of some collateral features. In presenting the following material from the point of view of pure theory, the diverse and sometimes unintelligible and illogical provisions of the corporation acts of the various states have been purposely ignored --- though of course in solving a concrete problem for a client the auditor must be guided solely (or largely) by the corporation act of the state of incorporation of the company.

(b) Evils of Par Value Stock.---As we have seen, in those states which require that par value capital stock be issued at not less than par, a corporation often has to, or finds it advisable to, circumvent the law because, among many other reasons, new stock at par does not usually appeal to the public half so well as when it can be bought at a "bargain", i.e. at a discount.

As treasury stock may be legally issued for whatever amount it will bring, the corporation will naturally plan to secure some. The most common step for a corporation to take toward this end is to issue capital stock for property bought at inflated values, the seller agreeing beforehand either to donate, or sell back to the corporation a certain number of shares at a very low price. In this manner, the corporation secures sufficient treasury stock for future sale by which to acquire its working capital more easily.

Furthermore, in the case of reorganizations the par value of stock tends to cause watered values, because the value of the net assets does not ordinarily approximate the par value of the shares which it is deemed essential to issue.

Likewise, it is no chimera, although trite, to state that the unsophisticated gullible public is often deceived by unscrupulous stock salesmen who intimate that a §100 par value stock which can be purchased for a lesser sum is of necessity a pure gain at someone else's expense.

(c) The Purpose of No-Par Value Stock.---No-par-value stock was sponsored in an effort to get rid of or alleviate the above and other objectionable features of par value stock. Of course, no-par value stock does not per se do away with these evils.\(^3\) In fact, most testimony is to the effect that the use of no-par-value stock has not served to eliminate or reduce the over-valuation of assets bought for capital stock, nor has it warned the investing public against the assumption of par value as representing true value. The real evil is undoubtedly due

1. See ADDENDUM.  
3. E.G. If assets are bought for no-par-value stock, the directors incur no liability for watered values, whereas with par value stock the stockholders or creditors may be able to hold the directors for the excess of par value over intrinsic worth.
in part to the laxity of the law which gives the directors too free a rein in valuing assets, and in part to the lack of a sense of social justice in business matters by business men. But, on the other hand, there is no denying that no-par-value stock does make it somewhat easier for straightforward management to act in accordance with true values, as opposed to nominal par values.

(d) The Taft Railroad Securities Commission.—At this point it is thought best to introduce an excerpt from the Report of the Railroad Securities Commission (1911). "We do not believe that the retention of the hundred dollar mark or any other dollar mark, upon the face of the share of stock, is of essential importance. We are ready to recommend that the law should encourage the creation of companies whose shares have no par value, and permit existing companies to change their stock into shares without par value whenever their convenience requires it. After such conversion, any new shares could be sold at such price as was deemed desirable by the board of directors, with the requirements of publicity as to the proceeds of the sale of such shares and as to the disposition thereof; giving to the old shareholders, except in some cases of reorganization or consolidation, prior rights to subscribe pro rata, if they so desired, in proportion to the amount of their holdings.

"As between the two alternatives of permitting the issue of stock below par, or authorizing the creation of shares without par value, the latter seems to this Commission the preferable one. It is true that it will be less easy to introduce than the other, because it is less in accord with existing business habits and usages, but it has the cardinal merit of accuracy. It makes no claims that the share thus issued is anything more than a participation certificate.

"The objections to the creation of shares without par value are two in number; first, that their issue will permit inflation, by making it easy to create an excessive number of shares; and second, that it will produce a division of stock into two classes, those whose shares have par value and those who have not. The second of these objectives does not appear to be a very serious one. There are listed on the stock exchanges today, side by side with one another, shares of the par value of one hundred dollars, shares of the par value of fifty dollars, shares with very much smaller par value, and a few, like the Great Northern Ore Certificates, with no par value at all. The share sells in each case simply for what the public supposes it to be worth as a share. The danger of inflation deserves more serious consideration. We believe, however, that it is more apparent than real, because shareholders will be jealous of permitting other shareholders to acquire shares in the association except at full market value, and will not permit the issue of shares to themselves at prices so low as seriously to impair the market or other value of their holdings. Shares either with or without par value, and whether sold at par or above par or below it, should, except in cases of consolidation and reorganization, be offered in the first instance to existing shareholders pro rata.

"The issue of stock without par value offers special facilities for consolidation and reorganization.

"When two roads consolidated whose shares have different market values, it has been the custom to equalize the difference by the issue of extra shares of the consolidated company to the owners of the higher priced stock. This practice has always tended to produce increase of capital issues, and may readily cause the new stock to be issued for a consideration less than its par value. The only alternative was to scale down some of the old stocks; and this often involved serious difficulties, both of business policy
and of law. By the simple expedient of omitting the dollar mark from the new shares, the number can be adjusted to the demands of financial convenience, without danger of misinterpretation or suspicion of unfairness to anyone.

"In the case of reorganizations the advantages of shares without par value are even more obvious. It is here that the necessity and justice of getting money from stockholders is greatest. It is here that the impossibility of getting them to pay par for new shares is most conspicuous. We believe that in such cases the public interest would be suberved and the speedy rehabilitation of the road promoted, by requiring the conversion of the common stock and encouraging the conversion of the preferred stock into shares without par value; the certificate simply indicating the proportion or preferential claims of the holders upon assets and upon such profits as might from time to time be earned.

"All of these considerations seem to apply with equal force to the securities of railroads under state incorporation, and we believe the laws of the several states could with advantage be modified so as to provide for the issuance of stock without par value."

(e) The First Legislation.--In 1912 the State of New York passed the first non-par value stock legislation in the United States. Today at least thirty-nine states have similar legislation, and, of course, those states which do not provide for this type of stock cannot forbid "foreign" corporations with such stock from doing business within the state.

The lead which New York took in 1912 really dates back to 1892. In that year a committee of the New York Bar Association recommended certain provisions which would enable the incorporation of a distinct class of business corporations with non-par value stock. Since then up to 1912 New York gave the matter of no-par value stock legislation considerable attention even to the extent of passing a bill through the legislature in 1907. It was killed, however, by the governor's veto.

(f) Stated Value.1--One of the troublesome features of a certain few no-par value stock statutes is the stated value provision; i.e., the amount below which the stock cannot be sold or later reduced. Thus it comes about that if anything more is received per share, the excess appears, according to these statutes, to be surplus, and as such is legally available for dividends. When this is true, the balance sheet presentation is somewhat as follows:

Common Stock (no-par-value)2

|Authorized and Issued 1000 shares with a declared value of $5 each| $5,000.00 |
|Paid-in Surplus| 49,478.59 |
|Total| $54,478.59 |
|Earned Surplus| 60,481.42 |
|Total Capital Stock and Surplus| $114,960.01 |

The above is undoubtedly the correct legal interpretation of the law of certain states, but is in contrary to sound reasoning which

1. See Appendix C, Sec. 14-12. 2. If no-par value stock is sold for less than its stated value less selling expense, the transaction is usually illegal. Although it is quite likely that the discount is an account receivable due from the stockholders and/or the directors, the facts are best presented by charging CASH, ORGANIZATION EXPENSE, and the deficiency to discount. Of course, if the stated value is greater than that required by law, the corporation can apply for a lower stated value.
affirms that whatever is paid in for the original no-par value capital stock is capital in toto. The balance sheet presentation from the point of view of correct theory, and that of the statutes of certain other states, is:

Common Stock (no-par-value)  
Authorized and Issued 1000 shares (with a declared value of $5 each)  
$54,478.59
Earned Surplus  
$60,481.42
Total Capital Stock and Surplus  
$114,960.01

(g) The Trust Fund Theory.—In this connection it seems desirable to point out that the stated value is clearly a carry-over from the idea of the trust fund theory which has long been associated with par value stock. This theory runs to the effect that since the personal liability of a stockholder to unpaid creditors is usually limited to the par value of the stock, in contrast to the unlimited personal liability of sole proprietors and partners, the amount invested in the corporation (plus any unpaid balance up to par) as represented by the par value of the stock represents a trust or guaranty fund for the protection of the creditors, and cannot be legally reduced by dividend declarations. This is in contrast to the unrestricted ease with which sole proprietors and/or partners may reduce their capital at will. In brief, the corporate advantage of limited liability necessitates the offsetting provision prohibiting the withdrawing of capital at will.

(h) Liquidating Value in Excess of Paid-in-Value.—As all stocks have the same rights except in the particulars denied or added to them, no-par value preferred stock shares equally with the common in instances of dissolution of the corporation. On the other hand, if the stock is made preferred as to assets, as is customary, the amount of the preference must be stated as so many dollars per share since there is no par value.

Unless there is a special reason to the contrary, the preferred stock with a special liquidation feature should be set up on the balance sheet at its original selling price, with the liquidating value stated in parenthesis.

If the liquidating value is used, the surplus is of necessity reduced by the extent it exceeds the amount paid-in. In the writer’s opinion there is no ground for impounding this surplus. All of it is available for dividends. The provision simply says that in event of liquidation the preferred stock shall be paid off first to the extent of the specified amount.

(i) Redemption Value in Excess of Paid-in Value.—In the writer’s opinion the case for setting up on the balance sheet the redemption value of preferred stock at some sacrifice to the common stockholders’ surplus is much clearer than it is for establishing the liquidating value. It is obvious that the common stockholders must relinquish their right to a certain definite amount of surplus at a certain definite future date. But it does not follow that all of it must necessarily be impounded at once. If, for example, the surplus is just sufficient to meet the total requirements, can it be supposed that the common stockholders must legally forego their dividends? In the writer’s opinion, a court of law would only require the corporation to impound or reserve yearly a proportional amount of the total surplus to be relinquished, computed as follows:

\[
\text{Excess of redemption value over paid-in value} \times \frac{\text{Life in years of the preferred issue}}{\text{Life in years of the preferred issue}}
\]
Changes to No-Par Value Stock.--In merely changing from par value to no-par value shares, it is not necessary to capitalize the existing surplus. No change whatever in the networth structure of the corporation needs to be made. The surplus accounts may remain as they are, and the amount represented by the capital stock may become the amount assignable in toto to the no-par-value shares. These may be either greater, equal, or less in number than the number of par value shares. The accounting entry to portray the transaction is exceedingly simple, thus:

Capital Stock (par value)

To close the former account into the latter, ______ shares of stock of $______ par value each being replaced by ______ shares of no-par-value stock.

Bonuses Stock.--It may be that some few states do not forbid the issuing of no-par-value stock FREE as a bonus, but most states do, and the weight of sound reasoning is decidedly against it.

If no-par-value stock is issued as a bonus with par value stock, the stated value is often assigned to the former and the balance of the proceeds to the par value stock. This procedure may result in a discount on the par value stock. If so, an account for it must be set up. This assumes, of course, that the corporate statutes allow par value stock to be issued below par. If not, the whole transaction is illegal. Furthermore, it is to be noted that the aforesaid procedure is solely to comply with the corporate statutes; it is usually fictitious as to actual facts, inasmuch as the assignment of values has been arbitrary.

Liability to Creditors.--When a stockholder has paid the subscription price, his no-par-value stock obviously becomes full paid and non-assessable.

Stock Dividend.--In instances of a dividend of par value stock, the amount transferred from surplus to capital stock must be equal to the total par value of the new shares issued. In the case of no-par-value shares, no amount whatever needs to be transferred, but the amount represented by the market value of the stock issued is thought by the writer to be a representative amount (assuming no stated value, otherwise at least this sum). Many, however, favor the use of average paid-in value.

Treasury Stock.--If treasury stock is legally acquired for cancellation, the portion of each of the Capital Stock and the Paid-in Surplus (if any) accounts which is applicable to one share of outstanding stock should be obtained by dividing each account by the number of shares outstanding. The two results are the respective values which should be charged to these accounts per share retired, the difference between the sum of them and the purchase price being a debit, or a credit to capital surplus.

Theoretically, each one of the various earned and capital surplus accounts should be adjusted for the portion of it that attaches to the Treasury Shares acquired in order to ascertain the correct profit or loss on the transaction. Practically, it is often impossible or inexpedient to follow this through the maze of surplus accounts. If such is not true in a particular case, the theory should be followed.

1. In most cases, however, there will be a transfer to (or from) the surplus account from (or to) the capital stock account.
2. Sometimes no entry is made for bonus stock issued for services, but this is deceptive. The proper debit is to surplus or organization expense according to the facts.
EXAMPLE

(Assumptions)

(1) Capital stock account (stated value $5) $5,000.00
(2) Paid-in Surplus 46,985.00
(3) 12 Other Surplus Accounts
(4) 1000 shares outstanding
(5) Purchased 10 shares at $65 each

(Solution)

\[
\begin{array}{c|c|c}
\text{Profit and Loss on Treasury} & \text{Capital Stock} & \text{Paid-in Surplus} \\
\text{Stock Transactions} & 65.00 & 469.85 \\
\text{Cash} & 650.00 & \\
\hline
\text{Total} & 519.85 & 51,465.15 \\
\end{array}
\]

If the above treasury stock is acquired (but not legally cancelled) for "permanent investment", the entry should be:

Treasury Stock 650.00
Cash 650.00

The balance sheet presentation thereof should be on the following order, $130.15 having been charged to Capital (majority opinion - earned) surplus in a Work Sheet adjustment.

Capital Stock (no-par value)

 Authorized and issued 1000 shares with a stated value of $5 per share $5,000.00
 Paid-in Surplus 46,985.00
 Total 51,985.00

Less-10 shares in treasury 519.85 51,465.15
(The 12 surplus accounts are omitted)

If treasury stock is acquired as a temporary investment, it may be treated on the balance sheet as if it were an asset, provided the amount is very small. The cost of the Treasury Stock must be reduced to market if the latter is below cost, preferably via a valuation reserve. If the market is above cost, it should be shown in parenthesis.

If a large amount of treasury stock is acquired as a temporary investment, it seems decidedly advisable to give it exactly the same balance sheet treatment as that given to stock acquired for permanent investment, but the account itself should be carried along in the ledger at full cost, the debit or credit adjustment to surplus being made by the auditor on his Work Sheet only. Some auditors, it may be stated, permit the excess of cost over total paid-in value to be carried (on balance sheet only—not on ledger) as an OTHER ASSET, instead of treating it as a charge to capital surplus. If the cost is less than the total paid-in value, these auditors credit the difference (on the balance sheet only— not in the ledger) to Contingent Profit on Treasury Stock, instead of to capital surplus. Of course, this procedure makes the auditor's balance sheet different from the books, but this is a matter of no real concern whatever being a very common occurrence.

1. When the account is allowed to remain at cost, the correct profit or loss is shown when the treasury stock is sold in the near future. This would not be true if the account were carried at average capital stock value.
2. This is entirely incorrect procedure.
3. In the writer's opinion this is unrealized capital surplus.
The Balance Sheet Presentation.—The balance sheet equities, i.e. liabilities and capital, should always be sharply separated as in plate 154. This is especially true whenever the statement is prepared primarily for the stockholders and the general investing public. Taken as a group, they do not understand accounts. Therefore, if the order of presentation is that still used by many of our leading corporations because of time-honored custom of presentation, namely, capital stock, fixed liabilities, current liabilities, deferred income, reserves (some being liabilities, some segregations of surplus, and/or some valuation accounts contra to assets). As shown in plate 154, the capital of the corporation should be separated into two groups, namely, capital stock and surplus. In regard to the capital stock, each class must be carefully and fully described including a statement of the amount authorized, issued, and in the treasury, the par value (if any) and the rate of dividends in the case of preferred stocks. Thus,

**Common Stock (without par value):**

<table>
<thead>
<tr>
<th>Class</th>
<th>Authorized and issued 20,000 non-voting shares</th>
<th>Having cumulative dividend rights of $7 per share in priority to class B stock</th>
<th>$xx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class B</td>
<td>Authorized 50,000 shares—Issued 10,000 shares</td>
<td>xx</td>
<td></td>
</tr>
</tbody>
</table>

Installments.—As stock often sells better than usual when it is offered to the investing public on the installment plan, it is frequently sold that way. Sometimes, however, this method is adopted simply because the corporation, especially if a new one, cannot use all of the subscription money at once. It takes considerable time to get buildings erected, machinery installed, labor hired and materials purchased. And considerably more time to coordinate and integrate them properly.

Naturally, some records must be devised to facilitate the handling of the numerous and special accounting entries which arise under such circumstances. Plates 213 and 214 give two records commonly used. When an installment is due, an entry for it is made in the General Journal somewhat as follows:

**Installment No.** xx

**Subscribers** xx

To record the call of installment # due this day, the details of which have been spread upon the Installment Ledger under the column headed Installment #.

The details of the debit to the Installment No. controlling account are posted to the individual names in the Installment Ledger (plate 213). In the same way the details of the credit posting to the Subscribers controlling account are posted to the individual names in the Subscribers Ledger. In some systems, however, only one of the two accounts is made a controlling account in order to cut down the amount of detail work.

As a part of the system, installments receipts (plate 214) are issued to the subscribers for each installment received. A convenient and orderly way to handle this situation is for the corporation to have an installment receipts book, with say several receipts per page. When the subscriber makes his payment, the form is filled out in his favor, detached from the stub, which contains a duplicate record of the facts, and mailed to him.
So much for some aspects of the accounting entries and records. It now requires but a comment or two on the verification procedure to complete this section.

The auditor should ascertain if all of the installments have been promptly met. If some are long overdue, he must see that the forfeitures, if any, are in accordance with the laws of the state. Moreover, if any special concession of any kind is made to a stockholder, the auditor should require an approval of it in the minutes of the board of directors. Credits to the Installment Ledger should be checked to the cash receipts book and thence into the bank. If property is received in payment, it should be accounted for as being on hand, and the authorization of it by the board of directors should be found in the minutes. Finally, the balances of the Installment Ledger should be proved to be in agreement with the controlling accounts.

687. See Plate 213.

688. See Plate 214.

689. Stock Subscriptions.—Whenever individual subscriptions to the capital stock of a company are solicited, the individual form of subscription blank (plate 215) is handy and convenient. When received, these subscriptions may then be used as Journal vouchers and summarized in a Subscription Journal (plate 216). From here the debit and credit grand totals are posted to the Subscribers and to the Capital Stock Subscribed accounts respectively. If the Subscribers' account is made a controlling account, as it often is, the details must be posted to the individual subscribers' accounts in the subsidiary Subscribers' Ledger.

In every application for a charter, the incorporators must state the amount of stock to which they subscribe. These subscriptions are irrevocable even though the business is not yet incorporated. This is not true, however, of the other subscribers even though they too have made application prior to incorporation. Up until the board of directors or an organization committee, if any, formally accepts the subscriptions, they are revocable.

690. See Plate 215.

691. See Plate 216.

692. Capital Stock Certificates.—Although it is not necessary for a corporation to have stock certificates if the stockholders so desire, nevertheless, it is exceptional to find an instance of this sort. A certificate may be a plain affair, but it is usually engraved and embellished to make it difficult to be reproduced, and to make it attractive respectively. Stock exchanges generally require that the certificates listed with it be engraved and otherwise protected, such as by having engraved in the body of the certificate the maximum number of shares that the particular certificate can possibly call for.

Capital stock must not be confused with certificates of capital stock (plates 105 and 107) for there is a distinct legal difference between the two. In popular parlance, however, the terms are used interchangeably. The certificates are merely evidences of ownership of the capital stock. If the certificates are destroyed, neither the capital stock nor the ownership of the stockholder is destroyed, as it would be in 1. Of course, it goes without saying that sums due from stockholders should be verified in part at least by direct correspondence for there is no reason for the client to object to it.
**A FORM OF INSTALLMENT LEDGER PLATE 213**

### INSTALLMENT BOOK

<table>
<thead>
<tr>
<th>S</th>
<th>Installment #1</th>
<th>40</th>
<th>C.</th>
</tr>
</thead>
<tbody>
<tr>
<td>H</td>
<td>Due on</td>
<td>7/1/29</td>
<td>B.</td>
</tr>
<tr>
<td>A</td>
<td>Amount</td>
<td>2000.00</td>
<td>B.</td>
</tr>
<tr>
<td>R</td>
<td>Due</td>
<td>2000.00</td>
<td>B.</td>
</tr>
<tr>
<td>E</td>
<td>Rec'd</td>
<td>7/6/19</td>
<td>B.</td>
</tr>
<tr>
<td>I</td>
<td>Remarks</td>
<td>7/9/19</td>
<td>B.</td>
</tr>
<tr>
<td>J</td>
<td></td>
<td>19</td>
<td>C.</td>
</tr>
<tr>
<td>K</td>
<td></td>
<td>19</td>
<td>C.</td>
</tr>
</tbody>
</table>

**Address**

- C.S. Aames: 716 Elk Rd., Ashton R.I., 503
- R. Aborne: 5 Oak Rd., Boston, Mass., 103

**Remarks**

- C.S. Aames: 100.00 Debit, 2000.00 Credit
- R. Aborne: 400.00 Debit, 400.00 Credit

---

**687. Explanation and Comments.**—Taken in conjunction with the text, this plate is practically self-explanatory. It should be remembered that this plate simply represents ONE way of drawing up this type of ledger.

**Note.**—J.F. means Journal Folio: i.e., the amounts in the debit "Amount Due" columns come from the General Journal, the entry therein (posted in total to the General Ledger) being somewhat as follows:

**Installment No. 1**

**Subscribers**

To record the call of installment No. 1 due this day. The details of the names of the subscribers etc. is shown in the Installment Ledger under Installment No. 1.

**C.B.F.** means Cash Book Folio: i.e., the amounts in the credit "Amount Received Columns" come from the Cash Receipts Book, the entry therein being similar to the following.

### CASH RECEIPTS BOOK

<table>
<thead>
<tr>
<th>Date</th>
<th>Name</th>
<th>Cash Debit</th>
<th>Sales Discount</th>
<th>L. Accounts F. Receivable</th>
<th>F. Installment #1 Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929</td>
<td>R. Maxon</td>
<td>980.00</td>
<td>2.00</td>
<td>12</td>
<td>100.00</td>
</tr>
<tr>
<td>6</td>
<td>G.S. Aames</td>
<td>2000.00</td>
<td></td>
<td></td>
<td>2000.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>R. Aborne</td>
<td>400.00</td>
<td></td>
<td></td>
<td>400.00</td>
</tr>
</tbody>
</table>

**Total**

| 254681.89 | 6731.20 | 130421.83 | 100000.00 |
|           | (12)    | (51)      | (15)       | (24)       |

The several amounts in the Installment #1 column are posted to the individual accounts in the subsidiary Installment Ledger, the grand total, $100,000.00 being credited to the Installment No. 1 controlling account in the General Ledger, page 24.

Only a portion of the Cash Receipts Book and of the Installment Ledger are shown.
THE JACKSON, MARSTON PAINT WORKS
Treasurer's Stock Installment Receipt

Installment No. 1  
Receipt No. 18  
Shares _10_  
Unit Par Value $100.00  

Received from _John Barker, Jr._ the sum of _Five Hundred_ Dollars ($500.00) installment payment No. 1 of Fifty Per Cent (50 per cent) upon his subscription of _10_ shares of the Capital Stock of THE JACKSON, MARSTON PAINT WORKS.

This receipt is to be returned in exchange for Certificates of Stock of said Company as soon as the full par value of said shares shall have been paid. Amount previously paid on above shares, _$300.00_ 

(signed) Alfred T. Marston 
Treas.

April 17, 1930

(Reverse Side)
Assignment Form

For Value Received, I hereby sell, assign and transfer to _the within receipt and the payment evidenced thereby._

Date _April 17_ 
Name ____________________

688. Explanation and Comments.—Before a business is incorporated, any funds which are secured from the sale of capital stock of the proposed corporation are held by trustees who issue installment receipts in acknowledgment thereof. After the charter has been secured, the treasurer receives those funds from the trustee and assumes their duties in this connection.

Generally speaking a stock certificate should not be issued until after the last installment thereon has been received and the installment receipts have been surrendered. However, some corporations have issued certificates before they have been fully paid for. In such instances provision is often, though not necessarily, made for the endorsement of future installments by providing a form on the back of the stock certificate. Thus,

INDORSEMENT OF INSTALLMENT PAYMENTS

<table>
<thead>
<tr>
<th>Required Installment Payments on the Within Contract as Follows</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of Installment</td>
</tr>
<tr>
<td>--------------------</td>
</tr>
</tbody>
</table>


A FORM OF INDIVIDUAL SUBSCRIPTION RECORD

THE RALSTONA CEREAL PRODUCTS COMPANY
11 1/2 Chelsea Avenue
Salem, Massachusetts

Authorized 1000,000 sh.
Par Value $50

To be incorporated by Messrs. John Barber, Samuel Irwin, Martin K. Salisbury, and George Winston, all of Salem, Massachusetts, under the Laws of the Commonwealth of Massachusetts for the making of cereal products.

I hereby subscribe for ..... shares of the Common Capital Stock of TheRalston Cereal Products Company at the par value thereof, and agree to pay Forty Per Cent (40 per cent) of such subscription on demand of the Company's Treasurer as soon as the said Company is incorporated and Forty Per Cent (40 per cent) at any time after three months from the date of said incorporation; the remainder of said subscription to be paid at such times and in such amounts, not exceeding Ten Per Cent (10 per cent) of said subscription in any one month as may be required by the Board of Directors of said Company.

Please issue certificate to ............................
Address..................................................

.................................................. Signature...

Date.....19......

(The right is reserved to reject or prorate any or all subscriptions.)

690. Explanation and Comments.--Whenever individual subscriptions to the stock of a company are desired, the individual form of subscription blank is often used. It can be conveniently sent through the mail or handed to individual inquirers and/or to persons whom it is desired to interest in the Company. In addition a prospectus which gives the past history and growth, the present profits and financial condition, the future expectations, and so on, of the enterprise is commonly inclosed.

The provision at the bottom of the subscription blank; namely, "The right is reserved to reject or prorate any or all subscriptions", is for the purpose of guarding against having to accept objectionable subscriptions. It is also needed to take care of instances where the stock is likely to be oversubscribed.

A subscription list, or sheet, has the same wording as the individual subscription blank, but the rest of the sheet is drawn up as follows:

(Reader's Note--The introductory wording has been omitted)

<table>
<thead>
<tr>
<th>Name</th>
<th>Address</th>
<th>Shares</th>
<th>Amount</th>
</tr>
</thead>
</table>


A FORM OF SUBSCRIPTION JOURNAL  PLATE 216

THE ATWOOD, CRAWFORD SPOOL MILL
17 Grand River Avenue
Chattanooga, Tennessee

Authorized 10,000 shares  Par Value $ 100

To be incorporated by Messrs. Ralph Comstock, Earl Jordan, and John Mason under the Laws of the State of Tennessee for the making of wooden spools.

We, the undersigned, hereby severally subscribe for and agree with Mr. Ralph Comstock, Trustee for the said Company and its incorporators, to pay at par value the number of shares of Capital Stock of the above said Company set opposite our respective signatures. Twenty Per Cent (20%) of said subscriptions becomes due as soon as the Company is incorporated, and the balance is callable by the Board of Directors on Ninety (90) days notice.

The right is reserved to reject or prorate any or all subscriptions received.

<table>
<thead>
<tr>
<th>Date</th>
<th>Name</th>
<th>Street</th>
<th>City</th>
<th>Sub. Shares</th>
<th>L</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/2/30</td>
<td>John Baxton</td>
<td>611 Gorge</td>
<td>Central Falls, R.I.</td>
<td>1</td>
<td>10 12</td>
<td>1000.00</td>
</tr>
</tbody>
</table>

Subscribers 7 1000000.00 10000 1000000.00

691. Explanation and Comments.—Naturally, the Subscription Journal is prepared from the subscription blanks (Plate 215) or list. As it is not a necessity, it is unknown to many small corporations. If used, the postings from it at the end of the month are a debit to Subscribers and a credit to Capital Stock Subscribed, or to equivalent general ledger accounts whatever they may be called.

Subscriptions are not binding unless and until they are accepted by the corporation or by the authorized trustee of the organization committee. Therefore, they are merely continuing offers, and, being such, can be revoked by the subscribers, up until they are formally accepted.

As it would be fatal to the incorporators to have some or all of the subscribers withdraw their subscriptions, it has been necessary for them (the incorporators) to devise means and ways of making the subscriptions binding prior to incorporation. That is to say that it takes two parties to make a contract, of which one party, the subscriber, exists, but the second party, the corporation, does not. Therefore, an Organization Committee or a Trustee is named by the incorporators to enter into contract with the subscribers until such time as the corporation comes into existence. Then, when the corporation has been chartered, it ratifies and accepts the rights and assumes the obligations of the Committee or Trustee. Moreover, in this connection it may be stated that the wording of the subscription list or blank should be carefully prepared by a lawyer well versed in this phase of law since it is said to be very difficult to prepare one which has no loopholes by which dissatisfied subscribers can withdraw.
case of paper money. Of course, the stockholder must make an affidavit and post a bond of indemnity with the corporation before it will issue to him a new certificate. But if he does not desire a certificate, he is none the less a stockholder of the corporation, and as such is entitled to all the rights and obligated to all the duties of one.

A share of stock does not convey ownership to any definite portion of the company's property. It does, however, give the stockholder the following individual rights: (1) to be notified of, participate in and vote at all stockholders' meetings; (2) to subscribe pro rata to any increase of capital stock; (3) on dissolution, to share pro rata in the remaining assets; (4) to share pro rata in the profits; (5) to prevent ultra vires acts on the part of the corporation; (6) to inspect the corporate books and records. Furthermore, in a collective capacity it gives the stockholder the right to participate in any action (1) to amend the charter; (2) to elect directors; (3) to sell the entire corporate assets; (4) to adopt, repeal or amend the by-laws; (5) to effect a dissolution of the corporation.

693. The Stock Certificate Book.--The stock certificate book contains the stock certificates (plates 105 and 107). As these are filled out in the name of the owner, they are detached from the stubs (plates 217 and 218), on which are entered the particulars of their issue.

As has been noted, sometimes this is the only capital stock record or book that a small corporation will have. If so, the sum of the shares recorded on the open stubs, assuming that the cancelled shares have been pasted to their respective stubs, as they should, must be seen to be equal to the number called for by the Capital Stock account (or accounts) in the General Ledger. It must be remembered that if an agreement between the two is secured, this is not absolute proof of the actual number of shares issued. For example, a certificate could be made out by an officer to himself for 100 shares, whereas the stub and also the cash receipts book may show only 5 shares. (It has been assumed that the second officer who is required to sign each certificate has signed a number of them in advance, as is often done where internal checks are lacking.)

Again, if there is collusion between the Secretary and the President, assuming that their signatures are the ones required, certificates could be taken from stock books whose existence is unknown to the auditor. Thus it seems advisable for the auditor to call for and scan all unused certificate books to see that no certificates have been abstracted out of order. Spoiled certificates must be saved, pasted to their stubs, and replaced by the next certificates in order—not by ones taken from the end of the book.

694. See Plate 217.

695. See Plate 218.

696. See Plate 219.

697. See Plate 220.

698. Stock Transfers.--Shares of stock may, of course, be sold, donated, mortgaged, or otherwise disposed of, or pledged. As the stock certificate is made out on its face in the name of some particular person, that person must endorse it, in the assignment form on the back of the certificate (plate 221), or sign a separate power of attorney (plate 222).
THE CALDER COTTON PRODUCTS CORPORATION
Second Preferred Stock
Certificate No. 812 Shares 60
Issued for ---------
Surrendered Certificates No. 253 170 Shares 80 40
Issued Certificates No. 812 813 Shares 60 60
Issued to Ethel Walker
711 Hawes St., Pawtucket, R.I.
On Sept. 19, 1930

Transferred from Paul Burroughs
612 Greene St., Central Falls, R.I.
On Sept. 16, 1930

Received the above described certificate No. 812
for 60 Shares
Subject to the provisions and limitations of the Charter
and By-laws as they now are, or may hereafter be.
This 24 day of September 1930
(Signed) Ethel Walker

694. Explanation and Comments.—The stub of a stock certificate
book corresponds to the stub of a check book. The certificate itself is
not shown, but its location is indicated by the words "The Stock Certifi-
cate".

This particular stub shows that Paul Burroughs turned in Certifi-
cates #170 and #253 for 40 and 80 shares respectively, and that 60 shares
were issued to Ethel Walker on this certificate #812, the other 60 shares
being issued to Paul Burroughs on certificate #813 (not shown).

As a rule, the lower section of this stub is not signed by the
new stockholder as the actual transferring is rarely done in person.
Certificate No. 1012
Date ___ Jan. 7, 1931 ___

Surrendered

<table>
<thead>
<tr>
<th>Name</th>
<th>Address</th>
<th>Folio</th>
<th>Shares</th>
<th>Certificate Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ronald Oleson</td>
<td>203</td>
<td>10</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>John Baxter</td>
<td>7</td>
<td>12</td>
<td>209</td>
<td></td>
</tr>
<tr>
<td>William Burne</td>
<td>16</td>
<td>30</td>
<td>18</td>
<td></td>
</tr>
</tbody>
</table>

Issued

<table>
<thead>
<tr>
<th>Name</th>
<th>Address</th>
<th>Folio</th>
<th>Shares</th>
<th>Certificate Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>William Burne</td>
<td>712 Poste St., City</td>
<td>16</td>
<td>13</td>
<td>1012</td>
</tr>
<tr>
<td>George Rallon</td>
<td>6 Ash St., City</td>
<td>519</td>
<td>39</td>
<td>1013</td>
</tr>
</tbody>
</table>

695. Explanation and Comments.—In the writer's opinion this form of stub is simpler and more satisfactory than the one in plate 217.

It shows that William Burne, having purchased stock from R. Oleson and J. Baxter, turned in 52 shares on certificate #7, #209 and #18. In return he got 13 shares on this certificate (#1012), the other 39 being issued to George Rallon on certificate #1013. The stub of this latter certificate would refer to stub #1012 for the full particulars of the whole transaction.

Notice that these stubs are used as a posting medium to the stock ledger; i.e., there is no transfer journal.
Scrip Certificate
THE BURY SHOE COMPANY
Special Stock

NO -----
Par Value of Shares $10.00 Each

One Half of one share

This is to Certify that the Bearer is entitled to One Half of one share of the Special Stock of the BURY SHOE COMPANY (issued pursuant to resolution adopted by the Board of Directors of the Company on July 21, 1923).

Upon presentation and surrender at the office of THE PEOPLES' LOAN AND TRUST COMPANY, Nos. 10-12 Main St., New York, N.Y., or the ATLAS TRUST COMPANY, No. 20 Broad St., Boston, Mass., of this certificate and another similar scrip certificate, the holder will be entitled to receive a certificate for one full share of Special Stock, of the par value of Ten Dollars.

The interest represented by this certificate is transferable upon the books of the Company only upon surrender of this certificate with another similar scrip certificate, as above provided, in exchange for a full share.

No dividends will be paid upon scrip.

Dated, Boston, September 14, 1923.

BURY SHOE COMPANY
BY ATLAS TRUST COMPANY
Transfer Agent

Registered
PLYMOUTH TRUST COMPANY
Registrar

By
Assistant Secretary

By
Assistant Secretary

696. Explanation and Comments.--As each stockholder is entitled to subscribe pro rata to any increase of capital stock of his class, it often becomes necessary to issue fractional shares to represent the rights of a stockholder which do not entitle him to subscribe to a (or another) full share. Generally speaking, these fractional shares are not left outstanding nor are dividends paid on them. The by-laws of a company usually state that they are void unless combined with other fractional shares (or sometimes money) necessary to secure full shares.
(a) The Face Contents of a Temporary Certificate

Incorporated under the Laws of the State of .........................
Temporary Certificate
Exchangeable for Engraved Certificate When Ready for Delivery ..........................Company
Shares $.............Each Capital Stock $.........................
This is to certify that .................is the owner of .................
Shares of the capital stock of .................Company, transferable only on
the books of the company by the holder hereof in person or by duly auth-
orized attorney upon surrender of this certificate properly endorsed.

Witness the seal of the company and the signatures of its duly auth-
orized officers, affixed this................... day of .........., 19......
....................................................Treasurer

....................................................President

(SEAL)
Countersigned.............
Trust Company
Transfer Agent
By.................................Secretary

 Registered........................................The Trust Company of .........................Registrar
 By.................................Secretary

(b) The Face Contents of a Certificate of Stock Partially Paid For.

Incorporated under the laws of the State of .........................Shares

.......................The .........................Company
Capital Stock $.................

This certifies that .........................is the owner of ................. shares of One Hundred Dollars each of the Capital Stock of the ................. Company, on which has been paid on each share the sum of .................Dollars, transferable only on the books of the Corporation by the holder hereof in person or by Attorney, upon surrender of this Certificate properly endorsed.

In Witness Whereof, the said Corporation has caused this Certificate to be signed by its duly authorized officers and to be sealed with the seal of the Corporation this ............... day of .........., 19......

....................................................President

(SEAL)

....................................................Secretary

 Shares, $100 each

697. Explanation and Comments.—(a) As stated in the certificate, tempo-
rary certificates are issued before the engraved certificates are ready for delivery, at which time they are exchangeable one for the other.

(b) This certificate is self explanatory.
in order to pass title. In case the purchaser desires a new certificate, he will fill in his name as transferee and forward it to the corporation for transferring. If the transferee has not designated in the assignment form someone to make the transfer on the books of the company, the transfer clerk will insert his own name and act in that capacity. A new certificate will then be issued to the transferee in his own name, and he will become the stockholder of record. A stockholder of record, not the actual holder or owner of the stock, is the person, it should be understood, whom the corporation recognizes as having the power to vote, to receive dividends, etc.

Under the common law, stock certificates are not negotiable, but in most states this disability has been overcome by statutory enactments. Some states have also adopted the Uniform Stock Transfer Act or a modified form thereof.

Certificates of stock which have been lost or stolen are not negotiable unless endorsed in blank by the owner. In such cases of loss, the owner under the Transfer Act can claim the certificates from the holder UNLESS this person has purchased them in good faith and for value, or unless the loser is guilty of too great delay in claiming it, or unless he has waived his right to claim it. Under the common law, the loser may claim the certificate wherever he may find it, since it is non-negotiable.

In endorsing the certificate, the owner must write his name so that it "corresponds with the name as written upon the face of the certificate in every particular without alteration or enlargement, or any change whatever."

If the name on the face of the certificate is wrong, it must be endorsed in the same manner and then followed by the correct signature.

In the case of unmarried women, the name on the certificate should be preceded by the word "Miss," and hence also in the endorsement.

A minor or other person who is incapable of contracting must use an "Attorney" who must present proof of his authority to make the transfer.

Under the rules of the N. Y. Stock Exchange, a married woman's signature must be witnessed by the husband, and both signatures must be witnessed before a notary.

The signature of a widow or an unmarried woman, if her name is not preceded by the word "Miss", must be acknowledged before a notary. In other instances any "legal" person may act as a witness to the assignment. In this connection it may be stated that the members of the N. Y. Stock Exchange ordinarily guarantee the certificates sold through them by endorsing their name under the witness's.

The transfer officer must take great care before permitting a transfer to be made, as a mistake may cost the corporation substantial damages. He must satisfy himself that the signature of the stockholder of record is a genuine one. If the transfer is signed by a corporation, he must be certain that the signature is by a proper official under authority, even to the extent of demanding a copy of the by-laws, or of the empowering resolution of the board of directors, together with a letter from the secretary of the company supporting the same. The certificate must also be acknowledged before a notary, and impressed with the corporate seal. If a transfer is made by a person as executor or administrator, he must give proof of his position by supplying letters testamentary or letters of administration, a certified copy of the will, and such other documents as the state laws may require. In brief, a transfer officer must have a thorough knowledge of common law and of the state statutes on the transferring of stock in order to conduct his office effectively.
701. Restrictions on Transfers.—When auditing close corporations, the question as to whether or not a corporation may restrict the transfer of its capital stock is sometimes presented to the auditor. Generally speaking, this prohibition is legal if the by-laws provide for it. However, it is not effective against purchasers who have no notice of it. Therefore, the restriction must be stated on each certificate, preferably on its face in a conspicuous location so that he who runs may read.

702. The Transfer Journal—The transfer journal or book often consists of blank forms, such as the one shown in plate 223 arranged one below the other, — say three or four to a page. As can be seen from plates 223 and 224, the journal is also valuable as a convenient posting medium to the stock ledger. However, in small corporations the posting is often made from the stubs of the stock certificate book.

The transfer form is filled in by the attorney who has been appointed in the assignment form on the back of the certificate (plate 221), or in the special power of attorney (plate 222). When no one has been appointed as attorney (plate 221), as is usually the case, the transfer clerk of the corporation (or the transfer agent, if one has been employed), fills in his name in the certificate and thus becomes empowered to fill out the form in the transfer journal.

In large companies the declaration of a dividend is sometimes accompanied by a notice that that transfer book shall be closed on a specified day for a certain few days. This procedure gives the corporation a breathing spell in which to prepare a list of the stockholders entitled to receive the dividend. The same practice of closing the books is sometimes followed before the annual meeting of the stockholders in order to get an accurate list of those entitled to vote. In many, perhaps in most instances, however, the transfer books are not closed on these occasions.

703. See Plate 223.

704. See Plate 224.

705. The Transfer Agent.—A transfer agent may be either a corporation or an individual. Usually, however, a bank or a trust company is appointed by a corporation as its transfer agent. The duty of a transfer agent is to transfer on the corporate records the stock from the seller to the purchaser. The agent must be certain that the certificate turned in is properly endorsed and that the owner had the power to sell the certificate under the law of the state in which the transfer was made, and/or under the rules of the Exchange where the sale was made. If transfer or stamp taxes are payable on the certificate, the transfer agent must see that the representative stamps have been affixed. Furthermore, the agent must keep
For Value Received _______ hereby sell, assign and transfer unto _______ the shares of the Capital Stock represented by the within Certificate, and do hereby irrevocably constitute and appoint _______ attorney to transfer the said stock on the books of the within named corporation with full power of substitution in the premises.

Dated __Sept._ 12, 1930 _______

Witness _G.E.Bartelle__ _______ By __William Baxton__ _______ (Seal)

Notice: - The signature to this assignment must correspond with the name as written on the face of the certificate in every particular without alteration or enlargement or any change whatever.

699. Explanation and Comments. -- This represents the assignment form customarily found on the back of a stock certificate.

This particular certificate has been endorsed in blank (i.e. no transferee is named) by William Baxton, the party whose name appears on the face of the certificate. The certificate is now negotiable from sellers to buyers without further endorsement. Eventually some purchaser will fill it in with his name as the transferee, and then send it to the corporation for transferring. The transfer clerk of the corporation or the transfer agent, if any, will write in his own name as the attorney to transfer, since the transferee will not ordinarily appoint one.

This attorney (the aforesaid clerk) must also sign his name to the form of transfer contained in the transfer journal (plate 223) of the corporation.

It is not necessary that the assignment form on the back of the certificate be used. A special power of attorney (plate 222) on a separate paper is acceptable and sometimes preferable.

If the owner of a stock certificate should insert in the assignment form the name of some one as attorney, this person could sell the certificate for the owner without having it transferred for a new one. This would be done by signing a substitute power of attorney either in blank or with the purchaser named as the new attorney. The following is such a form:

**POWER OF SUBSTITUTION**

I hereby constitute and appoint _______ our substitute to transfer the within named stock under the foregoing power of attorney, with like power of substitution.

Dated __________ 19_______

-- Signature --
KNOW ALL MEN BY THESE PRESENTS, That

for value received, have bargained, sold, assigned and transferred, and by these presents do bargain, sell, assign and transfer unto

Shares of the

standing in name on the books of the

and do hereby constitute and appoint the said

true and lawful attorney, irrevocable, for and in name and stead, but to own use and benefit and at own cost and charges, to take all lawful ways and means for the recovery and enjoyment thereof, and for that purpose to make and execute all necessary acts of assignment and transfer, and one or more persons to substitute with like full power, hereby ratifying and confirming all that said attorney, or substitute or substitutes, shall lawfully do by virtue herof

IN WITNESS WHEREOF, have hereunto set hand and seal the day of 19

Sealed and Delivered in the Presence of

(Seal)

700. Explanation and Comments.-- It is not necessary that the assignment form on the back of the stock certificate (plate 221) be used to transfer the stock. A special power of attorney, such as the one shown in this plate, is acceptable or preferable in some instances.

Whenever it is necessary to send stock certificates through the mail endorsed in blank, there is danger of loss, for certificates are negotiable (except under common law) from hand to hand without further signatures. Fortunately the hazard may be largely overcome by not signing the certificate, but in its place mailing under separate cover a separate assignment.

The same procedure of getting a separate assignment properly describing the certificate to which it relates, should be the policy of banks on all stocks which are received as collateral on loans made, etc. To repeat, there is some danger of loss through theft, etc., if stocks are held endorsed in blank.
For value received, I hereby sell, assign and transfer unto R. K. Watjen, Raulston, Ill., 21 shares and unto Florence Lewis, Worcester, Tenn., 44 shares. Shares of the Capital Stock of the Corporation now standing in my name on the Company's books and represented by certificate No. 31 and 207 for 40 and 25 shares.

Witness my hand and seal this 4 day of March 1930.

R. K. Watjen (L.S.)

By Sam Ross (L.S.)

Attorney

<table>
<thead>
<tr>
<th>SURRENDERED</th>
<th>REISSUED</th>
</tr>
</thead>
<tbody>
<tr>
<td>L. Ctf.</td>
<td>F. No.</td>
</tr>
<tr>
<td>R. K. Watjen</td>
<td>17</td>
</tr>
<tr>
<td>R. K. Watjen</td>
<td>17</td>
</tr>
</tbody>
</table>

703. Explanation and Comments. — In this assignment form, R. K. Watjen surrendered 65 shares on certificates #91 and #207, and there was issued unto himself 21 shares on certificate #610 and unto F. Lewis 44 shares on certificate #609. Very often there are three or four of these assignment forms to each page of the Transfer Journal.

The following legal quotation and comment are given to show the great degree of responsibility which the law places upon the transfer officer.

"The officers of the company are the custodians of its stock books, and it is their duty to see that all transfers of shares are properly made, either by the stockholders themselves or persons having authority from them. If upon the presentation of the certificate for transfer they are at all doubtful of the identity of the party offering it with its owner, or if not satisfied of the genuineness of the power of attorney produced, they can require the identity of the party in the one case, and the genuineness of the document in the other, to be satisfactorily established before allowing a transfer to be made. In either case they must act upon their own responsibility.

"In many instances they may be misled without any fault of their own, just as the most careful person may sometimes be induced to purchase property from one who has no title, and he may perhaps have acquired its possession by force or larceny.

"Neither the absence of blame on the part of officers of the company in allowing an unauthorized transfer of stock nor the good faith of the purchaser of stolen property, will avail as an answer to the demand of the true owner."—Western Union Telegraph Co. v. Davenport, 97 U.S. 369.

In Cincinnati Finance Co. v. Booth, 145 N.E. 545, the Supreme Court of Ohio awarded Booth damages in the amount of the market value of shares (which the Cincinnati Finance Co. had refused to transfer on its books) at the date of refusal to transfer the shares, all dividends declared during the interim, interest on both sums, and the costs of suit to Booth.
### FORMS OF STOCK TRANSFER JOURNALS (2d type) PLATE 224

#### (a)

<table>
<thead>
<tr>
<th>Date</th>
<th>Name</th>
<th>Surrendered Dr.</th>
<th>Issued Cr.</th>
<th>L. Stockholders</th>
<th>Stockholders</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Ctf.</td>
<td>Sh. Ctf.</td>
<td>Sh.</td>
<td>F.</td>
</tr>
<tr>
<td>1920</td>
<td>20</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Jan. 7</td>
<td>R.M. Watson</td>
<td>14</td>
<td>50</td>
<td>114</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>F.S. Somborn</td>
<td>115</td>
<td>140</td>
<td>10</td>
<td>140</td>
</tr>
</tbody>
</table>

#### (b)

<table>
<thead>
<tr>
<th>Date</th>
<th>By L. No. No. Date</th>
<th>To whom L. No. No. Par</th>
<th>Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>of Whom F. of of of assigned F. of of Value</td>
<td>issued, hereby acknowledge the receipt of the stock set opposite our respective names</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Assign Ctf. Sh. Issue ed</td>
<td>Sh. Sh. of</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stock--Cancelled Stock--</th>
<th>Issued</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>By L. No. No. Date</th>
<th>To whom L. No. No. Par</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$1,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Jan. 2</th>
<th>The Ohio Company...</th>
<th>Jan. 2</th>
<th>John Jones</th>
</tr>
</thead>
<tbody>
<tr>
<td>19...</td>
<td></td>
<td></td>
<td>1 1 10</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>John Jones</th>
<th>1 1 10</th>
<th>Feb. 29</th>
<th>Wm. Smith</th>
<th>26 31 10 1000</th>
</tr>
</thead>
</table>

704. Explanation and Comments.--(a) On January 7, R.M. Watson turned in certificate #20 for 100 shares and certificate #14 for 50 shares, and there was issued to him certificate #114 for 10 shares, the other 140 shares being issued to F.S. Somborn on certificate #115.

(b) This form is one proposed by the Secretary of State of the State of Ohio. "The hypothetical entries which appear in the last two forms indicate that on January 2nd, 19..., John Jones subscribed for ten shares of the capital stock of the Ohio Company, of the total par value of $1,000; that his ledger account is on Folio No. 1 of the Stock Ledger; that the number of stock certificate issued him for such ten shares is No. 1; that he received and receipted for such certificate; that on February 1st, 19..., he assigned the whole of said ten shares to William Smith; that on February 29th, 19..., said Smith presented said certificate to the secretary for transfer, and that a new certificate was issued to him, numbered 31, which was received and receipted for; that the further history of said ten shares begins in the ledger account of said Smith, on Ledger Folio No. 26."
a very complete and careful record of all cancelled certificates and all
issued certificates, including also a record of the names and addresses
of the owners thereof.

If a security is listed on more than one Exchange, or if the
corporation is a very large one, several transfer agents may be employed to
facilitate the transferring of the security. If so, an owner may use any
one of the agencies to get his newly purchased securities transferred to
his own name. Obviously, such an arrangement makes it necessary that each
transfer agent notify all of the others as to what transfers it has made.

706. The Registrar.—A registrar is usually a bank or a trust
company, appointed by a corporation to prevent the fraudulent overissuing
of a security. Under the rules of the New York Stock Exchange, a stock
must be registered by an outside corporation or other agency, i.e., a
bank, trust company, etc. In no case, however, can the registrar and
the transfer agent of a security be the same corporation. Thus it comes
about that the securities of our largest corporations are signed by a
registrar and by a transfer agent. (A corporation may have more than one
registrar and transfer agent.)

Upon issuing a certificate, the transfer agent will forward it
to the registrar together with the cancelled certificate. The registrar
will then sign the new certificate (or certificates), but having received a
cancelled certificate (or certificates) of like amount, it is not obliged
to ascertain if there is an overissue. If, however, the transfer agent
sends the registrar new certificates without any cancelled ones, he must
make certain from his records (which must check with those of the transfer
agent) that there is at least that amount of authorized (by the state)
unissued shares, etc.

From what has been said, it should be clear that the transfer
agent exists largely for the convenience of the security owners in getting
their securities recorded in their name, whereas the registrar exists for
their protection against a fraudulent over-issue of the security. Therefore,
small corporations very often act as their own transfer agent, but pay a
bank a fee to act as the registrar.

707. The Capital Stock Ledger.—The capital stock ledger (or
ledgers—there being at least one for each class of stock) (plates 225 and 226)
is subsidiary to the Capital Stock controlling account (or accounts) in the
general ledger. In the stock ledger is an account with each stockholder
showing the number of shares held by him and such additional information as
the business desires.

At the outset the stock ledger is likely to be posted from a special
journal, such as the one shown in plate 227, and thereafter from the transfer
journal, or, if none exists, from stubs of the stock certificate book.

In practically every instance the stock ledger will be found to be
one of the auxiliary capital stock records, if the corporation has any stock
records at all. Sometimes statutory law requires that this book be kept;
sometimes, especially in closed corporations, it is not kept, the facts be-
ing easily obtainable from the stock certificate book.

When there is neither a registrar nor a transfer agent, the auditor
must take a list of the balances of this ledger and tie it in with the
Capital Stock controlling account (or accounts). In addition, a test of the
entries may be made to show that the record is bona-fide and in good order.

708. See Plate 225.

709. See Plate 226.
(LEFT SIDE) Hazel B. Jordan, 174 Parket St., Pawtucket, N.H.

<table>
<thead>
<tr>
<th>Date of Transfer</th>
<th>To Whom Transferred</th>
<th>Certificate Numbers</th>
<th>Number of Shares Surrendered and Reissued</th>
</tr>
</thead>
<tbody>
<tr>
<td>1930</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feb. 1</td>
<td>George Baker</td>
<td>20</td>
<td>15</td>
</tr>
<tr>
<td>April 16</td>
<td>Robert Johnstone</td>
<td>81</td>
<td>40</td>
</tr>
</tbody>
</table>

(RIGHT SIDE)

<table>
<thead>
<tr>
<th>Date of Transfer</th>
<th>From Whom Transferred</th>
<th>Amount PAID on Shares</th>
<th>Certificate Numbers Issued</th>
<th>Number of Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929</td>
<td>Original Issue</td>
<td>Fully Paid</td>
<td>20</td>
<td>100</td>
</tr>
<tr>
<td>1930</td>
<td>Fred Barker, Ctf.7</td>
<td>&quot; &quot;</td>
<td>49</td>
<td>150</td>
</tr>
</tbody>
</table>

(b) Hazel B. Jordan, 174 Parket St., Pawtucket, N.H.

<table>
<thead>
<tr>
<th>Date Transferred</th>
<th>From or To</th>
<th>Surrendered</th>
<th>Issued</th>
<th>Surrendered</th>
<th>Issued</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929</td>
<td>Original</td>
<td>20</td>
<td>100</td>
<td>100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1930</td>
<td>George</td>
<td>20</td>
<td>100</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Baker</td>
<td>81</td>
<td>85</td>
<td>85</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Ctf. 80</td>
<td>15 shares</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Self</td>
<td>81</td>
<td>85</td>
<td>85</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fred</td>
<td>49</td>
<td>150</td>
<td>235</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Barker, Ctf.7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Self</td>
<td>317</td>
<td>45</td>
<td>195</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

708. Explanation and Comments.—(a) On January 1, 1929, H.B. Jordan purchased 100 shares on certificate #20. This certificate was surrendered on Feb. 1, 1930, 15 shares being transferred to George Baker. The balance of 85 shares being reissued to H.B. Jordan on certificate #81. On March 12, 1930, H.B. Jordan bought 150 shares of Fred Barker, certificate #49 being issued. Finally, on April 16, 1930 she surrendered certificate #81 selling R. Johnstone 40 shares thereof, 45 shares being reissued on certificate #317. In brief, H.B. Jordan now has certificates:

<table>
<thead>
<tr>
<th>Shares</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>49</td>
<td>150</td>
</tr>
<tr>
<td>317</td>
<td>45</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>195</strong></td>
</tr>
</tbody>
</table>

(b) These transactions are the same as those above in (a).
FORMS OF CAPITAL STOCK LEDGERS Plate 226

(a) Hazel P. Jordan, 174 Park St., Pawtucket, N.H.

<table>
<thead>
<tr>
<th>Date of Transfer</th>
<th>To Whom Transferred</th>
<th>Transferee's Shares</th>
<th>Cancelled Gross</th>
</tr>
</thead>
<tbody>
<tr>
<td>1930</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feb. 7</td>
<td>George Bakor</td>
<td>82</td>
<td>15</td>
</tr>
<tr>
<td>April 16</td>
<td>Robert Johnstone</td>
<td>316</td>
<td>40</td>
</tr>
<tr>
<td>June 27</td>
<td>F.S. Gross</td>
<td>814</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(b) John Jones, Columbus, Ohio

<table>
<thead>
<tr>
<th>Date of Issue</th>
<th>J. No. of Issue</th>
<th>From or to Whom Transferred</th>
<th>L. Certif. Transferred</th>
<th>No. of Certif. Issued</th>
<th>Date of Debtor Creditor Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>19..</td>
<td>1</td>
<td>From the Ohio Co.</td>
<td>1</td>
<td>Jan.2 $1000</td>
<td>$1000</td>
</tr>
<tr>
<td>Jan. 2</td>
<td></td>
<td>To Wm. Smith</td>
<td>32</td>
<td>Feb. 1 $1000</td>
<td>$1000</td>
</tr>
</tbody>
</table>

709. Explanation and Comments.--(a) This form of stock ledger is easier to understand than the one shown in plate 225. When a certificate is cancelled, the entry for it is put on the left hand side of the account opposite the corresponding entry (on the right hand side). Thus on April 16 certificate #317 for 45 shares was put opposite itself even though a line was "skipped". It is obvious that the outstanding certificates equal the difference between the ink totals (415-230) and are the open items: i.e., certificates #49 and #815.

(b) In this connection see also plate 224. "When said John Jones subscribed for said shares, he was debited in the ledger account with their par value, $1,000.00; that when he sold the same to said Smith, he was credited with the same amount; and that, as the debit and credit columns in his ledger account then balanced, this showed that his stock account was closed, and that he was no longer a stockholder in the company, having been succeeded by said William Smith, as to his whole holding of stock. Had John Jones sold his stock to more than one person, it would have been necessary to open an account in the stock ledger with each assignee."--Proposed by the Secretary of the State of Ohio.

Notice that this ledger account is kept in dollars and that the sum of the debit balances of the individual stockholders accounts would agree with the credit balance in the Capital Stock controlling account.
710. See Plate 227.

711. The Dividend Records.— Naturally, when a dividend is declared (plate 229), a list of the stockholders or record (plate 228) as of the specified date aids materially in the preparation and mailing of the individual dividend checks. Furthermore, when combined with prior lists, there is formed a compact permanent corporate record of those who have received the various past dividends.

It is common for large corporations to deposit the total amount of a dividend in a special bank account and to issue special dividend checks against it. Each check gives the date and number of the dividend, and such other details as the corporation desires. When such a fund is legally set aside, it is the property of the stockholders and therefore can not be shared in by other creditors if the corporation should become bankrupt.

712. See Plate 228.

713. See Plate 229.

714. See Plate 230.

715. An Audit Program.— The following is suggested as a basis on which an adequate program on the verification can be drawn up.

1. "The auditor should see that capital stock is stated on the balance sheet as required by the statutes of the State under whose laws the corporation is organized, the articles of incorporation, and the company's minutes. He must remember that the laws of certain States provide for both shares with and without par value and for special treatment in the case of no-par-value stock.

2. "If a trust company is the registrar of the capital stock for a corporation, it is sufficient, for verification purposes, to obtain from the registrar a certificate of the number of shares of capital stock outstanding.

3. "In the case of companies which issue their own stock, the stock registers and stock-certificate books should be examined to ascertain the amount of capital stock outstanding.

4. "On the balance sheet each class of stock must be stated, with the amount authorized, issued, and outstanding. If any stock of the corporation is held in the treasury, it should be separately shown, either as a deduction from the outstanding capital stock or on the asset side of the balance sheet, as the circumstances may require.

5. "When stock has been sold on the installment plan, the auditor should ascertain if any payments are in arrears. If special terms have been extended to any stockholder, the minutes of the board of directors should be examined to see that such terms have been approved.

6. "If any stock has been sold during the period under review, the auditor should verify the receipt of payment.

7. "In the case of companies having cumulative preferred stocks outstanding on which dividends have accrued but have not been declared, the facts must be mentioned on the balance sheet. All dividends declared but not paid at the date of the balance sheet should be included in the liabilities."

8. Ascertained if federal and/or state stamp tax laws, if any, have been complied with.

9. Ascertained what consideration was given for the treasury stock, and verify the method of handling and valuing the account.

10. Examine the treasury stock certificates and prepare a schedule of

"Verification of Financial Statements"—Federal Reserve Board.
A FORM OF CAPITAL STOCK JOURNAL FOR ORIGINAL ISSUES PLATE 227

<table>
<thead>
<tr>
<th>Date</th>
<th>Stockholder</th>
<th>Explanation</th>
<th>L</th>
<th>F</th>
<th>Cash</th>
<th>Stock Subscribed</th>
<th>Unissued Capital Stock Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1930</td>
<td>J.H. Booth</td>
<td>50 Shares</td>
<td>19</td>
<td></td>
<td>5000.00</td>
<td></td>
<td>5000.00</td>
</tr>
<tr>
<td></td>
<td>R.P. Rott</td>
<td>5</td>
<td>89</td>
<td></td>
<td></td>
<td>500.00</td>
<td>500.00</td>
</tr>
</tbody>
</table>

OMISSIONS

| Totals | 65000.00 | 85000.00 | 150000.00 |

710. Explanation and Comments.—A special journal like this one can often be used advantageously when recording the issuing of original shares. The journal is designed (1) to record the stock which is paid for and issued immediately, and (2) to record the issuing of stock on completely paid up subscriptions.
**Common Dividend No. 142 Date Payable 1-1-30**  
**Authorized Stock $1000000**  
**Rate % 3**  
**Amount $27000**  
**Outstanding Stock $900000**

This is a list of the holders of common stock of this Company as shown by the Stock Ledger at the closing thereof at five o'clock P.M. on December 27, 1929 and to whom the dividend of three (3) per cent, declared December 20, 1929, is payable on _January 1, 1930_.

<table>
<thead>
<tr>
<th>Name</th>
<th>Address</th>
<th>Shares</th>
<th>Ck.</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arthur Adams</td>
<td>711 Georgia Ave., Rowe, Ill.</td>
<td>100</td>
<td>1</td>
<td>$300.00</td>
</tr>
</tbody>
</table>

Prepared by _S. L. Hanson_  
APPROVED By _Geo. W. Lomax_  

---

712. Explanation and Comments.—In order (1) to facilitate the preparation of the dividend checks; and (2) to have a compact permanent record of the stockholders of record at each dividend date, a list, such as that shown in this plate, is often prepared. Many corporations put the money for the total dividend into a special bank account. Against this fund special dividend checks are drawn. As each one shows the number and date of the dividend, this answers the purpose of a voucher.

The following is a permanent dividend order as called for by column 2 of this plate.

To the Treasurer of the Moon Trading Company,  
10433 Morley Street, Pawtucket, R.I.  
Until this order is revoked in writing, please remit by mail to the address as stated in the margin, and by check drawn payable to the order of all dividends on the [name of stock] stock of the Moon Trading Company, now due, or that may hereafter be paid by your company on any shares of stock of said Moon Trading Company that may at the time stand in the name of .

Note.—This order must be signed by the stockholder in person or authorized representative, then papers showing authority must be filed with this order.

When the check is not to be drawn in favor of the stockholder the signature must be notarially acknowledged.

Name and address to which checks are to be sent.
Dividend Announcements Plate 229

(a) On Par Value Stock

CITY WATER CO.
of Charleston, Pa.
Preferred Dividend No. 10

The Board of Directors of the City Water Company of Charleston has declared the regular quarterly dividend of one and one-half per centum (1 1/2%) on the Company's 6% Cumulative Preferred Stock for the quarter ending April 30, 1930, payable May 1, to Stockholders of record at the close of business on April 19, 1930.

M. R. Porzelius
Superintendent

(b) On No-Par Value Stock

BURROUGHS & WALKER, INC.
of Central Falls, R.I.
Common Dividend No. 87

Notice is hereby given that a quarterly dividend (no. 87 of twenty-five cents (25¢) a share has been declared for the period ending November 30, 1930, on the outstanding no par value capital stock of this company.

This dividend is payable (Monday) December 15, 1930, to shareholders of record at the close of business (Wednesday) November 26.

Ethel F. Walker
Secretary

713. Explanation and Comments.-- (a) Note the three dates specified in the announcement; i.e., April 19, April 30, and May 1.

Dividends cannot be declared payable to stockholders of record of a date prior to the day on which the directors make the declaration.

Also, note that the transfer books were not closed for a brief period as is often the custom in order that an accurate list of the stockholders of record can be prepared as of the date specified.

(b) This plate is given to show the difference between the wording of an announcement on no-par value stock and one on par value stock.
A FORM OF SCRIP DIVIDEND—PLATE 230

THE CHATTANOOGA COAL COMPANY
Interest Certificate

No. 6131

By resolution of the board of directors of this Company, passed December 22, 1930, The Chattanooga Coal Company hereby certifies that John R. Mills being the holder of fifty (50) shares of the capital stock of said Company, is entitled to One Hundred Dollars ($100.00), payable ratably with the other certificates issued under said resolution, at the pleasure of the Company, out of its future earnings, with dividends thereon, at the same rates and times as dividends shall be paid upon the shares of the capital stock of said company.

This certificate may be transferred on the books of the company on the surrender of this certificate.

In Witness Whereof, the said company has caused this certificate to be signed by its President and Treasurer, this twenty-seventh day of December, 1930.

K. Frank Wilkinson
President

Philip L. Holt
Treasurer

For a valuable consideration I, ___________ do hereby assign, and transfer all interest in the above certificate to ___________ and do hereby irrevocably appoint ___________ attorney, to execute a transfer thereof on the books of the ___________ Company therein mentioned.

714. Explanation and Comments.—As can be seen by this plate, a scrip dividend is like a promissory note. In some instances it bears interest and/or has a definite maturity date. Such dividends are likely to be issued whenever the corporation needs to conserve its cash. If the scrip is in negotiable form, it may be readily dealt in on the security exchanges.
(11) Ascertain how premiums and discounts, if any, have been handled in the accounts.
(12) Ascertain if the treasury stock (if any) really is treasury stock, or merely unissued stock.
(13) Check the total of dividend lists against the amount of outstanding stock.
(14) Analyze the account from beginning to end, ascertaining what was received for the stock.
(15) Abstract the provisions of each class of stock including such possible features as call price, sinking fund provisions, participation, liquidating value, etc.
(16) Abstract the charter.
(17) Abstract the by-laws.
(18) Abstract the special features of the corporation law of the state of incorporation. Follow it exactly both in the accounting entries and in the balance sheet presentation. If not, be prepared to justify your exception.
(19) Examine various authorizations of additional issue or reduction granted under seal by the Secretary of State.
(20) Examine the Stockholders Minutes, and those of the Board of Directors as to subscription price, dates of call, method of payment, stated value, portion assigned to paid-in-capital, etc. In some instances request action on these matters if none has been taken.
(21) If feasible, analyze the capital stock accounts from date of incorporation to date of audit.
(22) Always secure a certificate from the Registrar when one is employed. (If more than one registrar, then from each one.)
(23) If no registrar is employed, prove the open stubs of the Stock Certificate Book against the controlling account in the General Ledger. Do the same with the Capital Stock Ledger.
(24) Ascertain the corporation law on forfeitures of capital stock subscriptions.
(25) Ascertain the corporation law on the kind of surplus(es) available for dividends.
(26) Ascertain to what extent treasury stock may be legally purchased.
(27) On detailed audits make a comprehensive test of the Transfer Journal (if operated by the client). On balance sheet audits no test is required, but it is usually advisable to test, review and scrutinize a few transfers if time permits.
(28) When "watered" stock exists, the auditor, in the absence of fraud, need not challenge the directors' valuations. However, he must take pains to make a full disclosure of the fact that "it is a directors' valuation".
(29) "It may require a long explanation to describe dividend and redemption provisions, but the auditor is charged with the duty of declining to certify a balance sheet unless it is an accurate picture."—R. Montgomery.
(30) Unless required by the vote of the Board of Directors, the auditor should not use the stated value as the amount to be assigned per share to the capital stock account. The whole amount paid-in should be credited to this account.
(31) Check all cash received from the sale of stock as per the credit entries in the capital stock account into the Cash Receipts Book, and thence into the bank.
(32) Check credits to the Installment Ledger to the Cash Receipts Book, and thence into the bank.
(33) When property, other than cash, is paid in by a subscriber, account for it as being on hand (or if sold since account for the consideration
received for it) and as being authorized by the directors. See that the title is in the name of the client. Do the same when the proceeds are services.

(34) Test-check entries into the Subscribers' Ledger. Foot, and test the accuracy of the balances. See that the balances of the Subscribers' Ledger are in agreement with the Subscribers controlling account in the general ledger.

(35) Do the same with the Installment Ledger.

(36) Ascertain if the client is pasting the cancelled stock certificates to their respective stubs in the Stock Certificate Book, or otherwise properly preserving them. See that they have been properly cancelled. Properly authenticated cremation certificates are acceptable evidence of destroyed certificates.

(37) Ascertain if the transferred capital shares are really cancelled, such as by perforation.

(38) Ascertain if the blank shares are being signed in advance by one of the two signatories of the issuing corporation.

(39) Scan and review unused certificate books. Have them sealed, and thus avoid this clerical work. Have them placed under the JOINT custody of the signatories.

(40) If feasible, test-check to see if the cancelled shares have been properly endorsed by the one entitled to make the transfer.

(41) In some few instances it may be necessary to comment on the poor quality of the stock certificates. The possibility of photographing, etc. should always be considered.

(42) "Give special attention to those items on the trial balance (of the stock ledger) which show stock standing in the name of the corporation under audit, or in the name of the treasurer as such. If such stock has been actually issued, check with the schedule of treasury stock; if nominally issued, verify with any agreements of pledge, etc."--F.W.K.

(43) "If the proceeds from the sale of stock are to be used for a special or restrictive purpose, examine the provision in the stock agreement with respect to the handling and disbursing of the funds, and verify that the provision has been conformed to."--F.W.K.

(44) When services have been received in payment of capital stock issued, ascertain if ALL of the services required have been received. Always give full details: such as, name of person who is to render the services, the kind of services, the extent (from when to when, etc.) of the services, etc., etc.

(45) See that stock is not issued unless fully paid for. Exceptions must be fully justified.

(46) Make certain that the discount, if any, is neither expensed to operations nor capitalized as plant property, etc.

(47) Make certain that the premium, if any, is neither treated as current income nor as surplus available for dividends.

(48) "Inquire into all instances where the stubs of the stock certificate book show that certificates have been issued to replace certificates lost or destroyed. Examine by-laws and, where an indemnity bond is required for a new certificate, verify the existence of the bonds, the adequacy of the amount, and the rating of the surities."--F.W.K.

(49) All voided certificates should be on hand, being attached to their respective stubs.

(50) Abstract the provisions of the preferred stock(s). Set forth any special provisions, such as the privilege of converting the stock into bonds, in balance sheet footnotes. What provisions, if any, have been violated?

(51) Make certain that the unissued stock is not called treasury stock.
Also, see that it is not treated as an asset.

(52) Ascertain if cash, scrip, stock, or other dividends on treasury stock, if paid thereon, are properly handled. Do not permit them to be treated as income.

(53) In the case of sale of a new issue of stock, etc., during the period under review, examine all correspondence with the investment house, which handled the issue, for selling price, commission, etc.

(54) When preferred stock has been retired during the period, (1) examine the agreement as to the time and terms of redemption (2) verify the payments in the Cash Payments Book against the cancelled checks, "comparing the indorsements on the checks with the names on the certificates surrendered", (3) examine the surrendered certificates, seeing that they are correct in number of shares, that they are properly indorsed, and that they have been properly cancelled.

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

--F.W.T.

(56) Remember that notes of subscribers can not usually be legally accepted in payment of stock.

(57) "The amount of stock reserved for issue under agreements, warrants and conversion privileges should be stated on the balance-sheet, so that the possible effect of the issues may be seen. Commitments to repurchase stock and amounts of cumulative dividends in arrear should appear for the same reason."--F.W.T.

716. See Plate 231.

717. See Plate 232.

718. See Plate 233.

ADDITION 1

CORPORATION REPORTS

"On January 12th the stock list committee of the New York stock exchange issued the following letter addressed to the chief executives of corporations:

"Dear Sir: In line with our constant efforts to secure reasonable uniformity in annual reports for the benefit of listed companies, their shareholders, accountants, and the investing public, this committee is herewith advising you of its general attitude as to the following features of such reports:

"(1) When the books and accounts have been audited by public accountants, the text of their auditor's certificate should be given.

"(2) The number of shares of capital stock, both common and preferred, authorized by the charter and the amount outstanding should be shown in the balance-sheet.

"(3) The number of shares and the amount of holdings of own unretired stock and bonds should be separately disclosed, with indication of the valuation and the basis at which carried.

1"Journal of Accountancy, Feb. 1932, p.146."
"(4) Surplus should be separated at least into capital surplus and earned surplus should be indicated by adjustments thereto.

(5) Any changes for the period covered in either capital surplus or earned surplus should be indicated by adjustments thereto.

(6) Differences between cost and subsequent retirement or resale of the company's own stock should be fully disclosed. This committee prefers that such differences be reflected directly to the capital surplus account, especially where common stock, and preferred stock without compulsory retirement features are involved. There is, however, some difference of opinion among accountants upon this point, and there are those among them who consider that such differences may properly be reflected in earned surplus instead of in capital surplus. Listed corporations are generally under agreement to submit future statements to stockholders in the same form as those contained in the listing application. Where it has been the practice of such corporations to reflect any so-called profits arising from these transactions through the capital surplus account, this committee feels that it would be a violation of the agreement in question should any change in the practice be made. Until further consideration of the matter, however, no objection will be made if corporations, whose practice in this respect is not affected by the agreement to publish in the same form, should follow the advice of their accountants upon this point, provided full disclosure of the source of such additions is given and that the transactions are included directly in the surplus account and not in the income account.

(7) Full disclosure should be given of any change since the previous annual report in the basis of valuation in investments, inventories, or property account.

(8) Full disclosure of any change in the depreciation policy should be given.

(9) If other income represents a substantial part of total income, the principal component items of other income should be disclosed.

(10) This committee does not deem it advisable to establish at this time requirements as to the method by which revised or fluctuating rates of foreign exchange should be reflected in the consolidated balance-sheets or earnings statements of listed American companies having foreign subsidiaries subject to these factors, or in the parent company statements of listed American companies themselves having assets, liabilities, or earnings similarly affected. Irrespective of the method followed, disclosure should be given of the basis on which such items are reported.

(11) A list of officers and directors should be included in the report.

"This circular letter is not intended to affect in any way cases in regard to the above points which already have been taken up individually with this committee."
716. Explanation and Comments.—A warrant is the tangible evidence of a stock right, which is, of course, the privilege given to stockholders of record to participate in an increase of their class of stock or in a different class of stock issues. Conversion warrants are attached to and non-detachable from the stock certificate. Such warrants give the stockholder the right of converting some or all of his stock into a different (usually specified) class of stock if exercised within the specified time (or times), and often at an additional cost (sometimes specified). Other types of warrants are attached to but detachable from the stock certificates at any time but not exercisable until specified therein. Lastly, warrants are most often issued entirely independent of the stock certificate.

The following appears on the back of this particular warrant.

EXPLANATION OF THE FOLLOWING FORMS

No. 1 to be executed by persons desiring to subscribe.
No. 2 to be executed by the holder in case he desires to dispose of his rights to subscribe.

1. SUBSCRIPTION

TO AMERICAN POWER CORPORATION:

The undersigned hereby subscribes for the shares of stock mentioned in the within warrant and makes payment therefor in full herewith. You are hereby authorized to issue the certificates for such shares to __________ whose address is __________

(signature)

Dated __________

Certificates are desired in the following denominations __________

2. ASSIGNMENT

FOR VALUE RECEIVED, the within warrant and all rights evidenced thereby are hereby assigned and transferred to __________

(Address of person to whom assigned)

(Signature of Holder)

(Address)

WITNESS:

(Signature)

(Address)

A holder wishing to subscribe for a portion of the shares of stock mentioned in the within warrant and to dispose of his right to subscribe for the remainder, or wishing to dispose of a portion of his subscription rights to one person and the remainder to another person may, on or before June 26, 1930 return this warrant to the corporation, with precise written instructions, and receive other warrants in exchange herefor.

NOTICE: The signature of this assignment must correspond with the name as written upon the face of the warrant, in every particular, without alteration or enlargement or any change whatever. When assignments are executed by administrators, executors, custodians, guardians, attorneys, etc. proper evidence of their authority so to act, must be on file with the corporation.
A FORM OF WARRANT PLATE 231.

AMERICAN POWER CORP.
A corporation of the state of Delaware

DEFINITIVE OPTION WARRANT FOR SUBSCRIPTION
FOR CLASS A COMMON STOCK

No. 10845

This is to Certify ———RAYMOND JORDAN———
that

| TEN | SHARES |

right to subscribe for

10 SHARES

or assigns, is entitled to subscribe, on or before June 30, 1930 for

of the Class A Common Stock of AMERICAN POWER CORPORATION (hereinafter called the Corporation) as $20 a share on or before September 30, 1929, or thereafter and on or before June 30, 1930, at $24 a share but only upon:

(1) Signing Form No. 1 on the back of this warrant and surrendering the warrant at the office of the Corporation in the Rapids National Bank Bldg., Rapids, Michigan (a) on or before September 30, 1929, if the subscription be made at $20 per share, or (b) thereafter and on or before June 30, 1930, if the subscription be made at $24 a share; and

(2) at the same time paying the Corporation at its said office the subscription price in full in funds there current and free from collection charges.

Certificates of stock will be issued as soon as possible after payment is received.

This warrant may be transferred by assignment in the form on the back hereof.

This warrant will be wholly void and of no value after June 30, 1930.

Dated June 6, 1930

AMERICAN POWER CORPORATION

By George Halliwell
Assistant Secretary
EXPLANATION OF PLATE 232

A FORM OF STOCK RIGHT

717. Explanation and Comments.-- Very frequently corporations give their stockholders the right to subscribe to new stock issues at a price below what the stock is selling for on the market. To handle the situation conveniently, "warrants" or "rights" are issued to the stockholders in proportion to their holdings. In this particular instance, each stockholder is entitled to the right to subscribe to one-tenth of one new share for each share of old stock held; hence, Charles Mitchell & Co. must have held eleven old shares.

As a right gives the old stockholder the opportunity to purchase the new stock at a bargain, it has value on the market. Before rights are issued, they are traded in on a "when, as, and if issued" basis. The old stock sells "rights-on" from the date of the definitive action of the board of directors up to the day fixed by the Committee on Securities of the N. Y. Stock Exchange for selling such stock on an "ex-rights" basis. This is ordinarily the day on which the stockholders of record are listed as the ones to receive the "rights".

The following appears on the back of this particular stock right.

EXPLANATION OF THE FOLLOWING FORMS:

1. To be executed by the party desiring to subscribe.

2. To be executed by the party whose name appears on the other side hereof, in case he desires to dispose of the privilege.

(1) SUBSCRIPTION

To GRANT MOTOR CAR CORPORATION:

c/o Grant Bank & Trust Co., 55 Cedar St., New York, New York

The undersigned hereby subscribes for all (or only ) of the shares of the capital stock of a par value of $10.00 per share, covered by the within Warrant, upon the terms stated therein.

Signature

Address

(2) ASSIGNMENT OF PRIVILEGE

FOR VALUE RECEIVED the right to make the within mentioned subscription is hereby assigned to

(name of party to whom assigned)

(address of party to whom assigned)

Dates 1930

Witness Signature

Note: Signatures must be guaranteed by a bank or trust company having an office or correspondent in the City of New York, or by a brokerage house having a membership in the New York Stock Exchange. If the subscription or assignment is executed by an attorney, agent, trustee, executor, administrator, guardian, or in any fiduciary capacity, the person so executing the subscription or assignment must give his full title as such attorney, agent, trustee, executor, administrator or guardian or in such capacity; and proper evidence of authority to act as such or in such capacity must be forwarded with this Warrant.

The signature to this assignment must correspond with name as written upon the face of this Warrant, in every particular, without alteration or enlargement or any change whatever.
A FORM OF STOCK RIGHT PLATE 232

PRICE MOTOR CAR CORPORATION

This is to certify CHARLES MITCHELL & CO. that

One and One-tenth
$8.00 per share, for

SHARES

or at the option of the holder hereof, any less number of shares of the capital stock with a par value of $10 per share of Price Motor Car Corporation, a Rhode Island Corporation, hereinafter called the Corporation. Payment therefor must be made in full at or before 3 o'clock P.M., May 9, 1930, in New York funds, free from collection charges, at the Stock Transfer Department of Grant Bank & Trust Company and as soon as practicable after surrender of this Warrant and payment of the subscription price, as herein provided, stock certificates will be issued to the subscribers entitled thereto. All checks in payment of subscriptions must be made to Grant Bank & Trust Company. No allowance will be made for interest on payments made before said date. No subscriptions for a fraction of a share will be accepted.

This Warrant will be void and of no value unless surrendered at or before 3 o'clock P.M., May 9, 1930, at the above specified office of Grant Bank & Trust Company, accompanied by payment of the subscription price in full. It is a condition of this Warrant, and every successive holder hereof by accepting or holding this Warrant consents and agrees that title to this Warrant when properly endorsed, is transferable by delivery with the same effect as in the case of a negotiable instrument. Also this Warrant may be transferred on the books at the said office of the Grant Bank & Trust Company upon surrender of this Warrant, properly endorsed.

The Company may treat the holder thereof of record on said books as the absolute owner thereof for all purposes, without being affected by an notice to the contrary.

Upon surrender hereof, at or before 3 O'clock P.M., May 9, 1930 at said office of Grant Bank & Trust Company this Warrant may be divided into one of more Warrants representing in the aggregate the subscription rights represented by this Warrant.

On the back hereof are two forms, the first to be dated and signed, if subscription is to be made; and the second which is an assignment requiring a witness to be dated and signed, if the subscription privilege is to be disposed of.

This Warrant is not valid until countersigned by the Transfer Agent.

PRICE MOTOR CAR CORPORATION

Countersigned:

By

Grant Bank & Trust Company (Trans. agent)

Paul Burroughs (signed) James Jordan (signed) Norman Walmsley (signed)

Authorized Officer Assistant Treasurer Vice-President

No. N.Y. 2504

SUBSCRIPTION WARRANT

For shares of Capital Stock of par value $10 of

1 1/10 SHARES

being at the rate of one-tenth share for each share of par value $10 held of record at 3 P.M. April 1, 1930

VOID AFTER 3 P.M. MAY 9, 1930

To subscribe for

On or before May 9, 1930

at the price of

$8.00 per share, for

SHARES

The Company may treat the holder thereof of record on said books as the absolute owner thereof for all purposes, without being affected by notice to the contrary.

Upon surrender hereof, at or before 3 0’clock P.M., May 9, 1930 at said office of Grant Bank & Trust Company this Warrant may be divided into one or more Warrants representing in the aggregate the subscription rights represented by this Warrant.

On the back hereof are two forms, the first to be dated and signed, if subscription is to be made; and the second which is an assignment requiring a witness to be dated and signed, if the subscription privilege is to be disposed of.

This Warrant is not valid until countersigned by the Transfer Agent.

PRICE MOTOR CAR CORPORATION

Countersigned:

By

Grant Bank & Trust Company (Trans. agent)

Paul Burroughs (signed) James Jordan (signed) Norman Walmsley (signed)

Authorized Officer Assistant Treasurer Vice-President
Incorporated Under The Laws Of The COMMONWEALTH
Certificate of Full Paid
for less than MASSACHUSETTS and Non-Assessable
THE A.B.CURTIS RAYON CORPORATION

Authorizing
Common Stock Capital Stock $5000000
$3000000 SHARES

This is to Certify that _________ is the owner of _________ Shares of the
COMMON STOCK OF THE A.B.CURTIS RAYON CORPORATION transfer-
able only on the books of the Corporation by the holder
hereof in person or by duly authorized attorney upon sur-
rennder of this certificate properly endorsed.

The preferred stock shall be entitled to receive div-

This certificate is not valid without the signature
cidends at a rate not exceeding eight per cent (8%) per
of the Registrar.

Dated __________

No.of
Orig. Ctf._Shares_

Issued
No.____Shares____

Received Ctf.No._

for ____ Shares

Thou. Hun. Tens Units
1 1 1 1
2 2 2 2
3 3 3 3
4 4 4 4
5 5 5 5
6 6 6 6
7 7 7 7
8 8 8 8
9 9 9 9
0 0 0 0

Explanation and Comments.-- This plate is self explanatory.
1. What is the general procedure for securing an increase in the authorized capital stock?

2. Give a full description of the procedure to be taken in auditing the Capital Stock accounts on a first audit.

3. Are ordinary stocks ever subject to assessments beyond the par value paid in?


5. A corporation legally reduces its capital stock. Can this resulting surplus be used to wipe out a deficit, or must an auditor show the two facts separately?

6. Why does an auditor need to see the company's charter?

7. Why do stock exchanges require that the registrar be a different person or company than the transfer agent?

8. Draw up a master schedule on capital stock and support it by at least two sub-schedules. Be certain to cross index each schedule to an abstract of the charter and of the minutes, and to other related analysis sheets.

9. In what state and when was the first no-par stock legislation?

10. What is meant by the term watered stock?

11. In what account should capital stock assessments in excess of par value be credited?

12. In what way is the stated value of no-par value stock a stumbling block?

13. An auditor feels that certain property which has been purchased with capital stock is overvalued. What is his duty in this situation? Why?

14. What is the gist of the trust fund theory?

15. Should an auditor certify to a poorly drawn up statement such as the one in Plate 131? Why?

16. Do you favor setting up in a special account a portion of surplus to the amount of the unpaid cumulative preferred dividends?

17. Are national bank stocks ever subject to additional assessments beyond the par value paid in?

18. State a provision which might be found in a stock, the presence of which will vitally affect the balance sheet.

19. What is the provision in the last paragraph of section 8623-22 of the Ohio corporation act? Is this a sound provision? Why?

20. Is it legal in this state to pay out as dividend assessments made on capital stock in excess of par value paid in?

21. What were the recommendations of the Taft Railroad Securities Commission?

22. State several evils of par value stock.

23. The redemption value of a no-par value preferred stock is in excess of the paid in value. How would you present this fact on a balance sheet?

24. Is it good practice to issue a bonus of no-par value stock? Why?

25. How would you record in the ledger and present in a balance sheet, no-par value treasury stock which has been purchased for cancellation?

26. How does the Subscription Journal of Plate 216 operate?

27. To what extent should the capital stock ledger be audited?

28. How would you show on a balance sheet the liquidating value of no-par value preferred stock when it is in excess of the amount paid in?

29. From what books of original entry do the various entries in the Installment Ledger come?

30. Describe two types of capital stock frauds that would not be uncovered by proving that the open stubs in the stock certificate book are in agreement with the capital stock controlling account.

31. Describe the method of changing from par value to no-par value stock.
REVIEW QUESTIONS

(Continuation)

32. Is it necessary for a corporation to have shares of stock?
33. What is the usual procedure for obtaining a new stock certificate to replace one which has been destroyed or lost?
34. How would you record in the ledger and present in a balance sheet a small amount of no-par value treasury stock which has been purchased as a temporary investment?
35. Describe the method of recording on the books of the issuing corporation a stock dividend of no-par value stock.
36. What is an installment receipt? Draw one up.
37. Must shares of stock be engraved and embellished?
38. What are the collective rights of a stockholder?
39. What is the procedure for auditing installments?
40. What are the duties of a stock registrar?
41. Distinguish between capital stock and certificates of capital stock.
42. How would you record in the ledger and present in a balance sheet no-par value treasury stock which has been purchased for retirement but not cancellation.
43. What is a stock power of attorney?
44. What are some of the various rules and regulations in regard to signatures on stock certificates?
45. Write several paragraphs on "The Transfer Agent".
46. Who is a stockholder of record? What are his rights?
47. A certain corporation has had some treasury stock donated to it, but has not made any entry for it. Do you approve of this procedure? Why?
49. What are the individual rights of a stockholder?
50. What is the book value per share of the preferred stock?

<table>
<thead>
<tr>
<th>Class of Stock</th>
<th>Par Value</th>
<th>Number of Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>$100</td>
<td>100,000</td>
</tr>
<tr>
<td>6% Preferred Stock</td>
<td>$100</td>
<td>100,000</td>
</tr>
<tr>
<td>Premium on Common Stock</td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>Premium on Preferred Stock</td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>Earned Surplus</td>
<td></td>
<td>15,000</td>
</tr>
<tr>
<td>Preferred dividends are 3 years in arrears</td>
<td></td>
<td></td>
</tr>
<tr>
<td>It is non-participating stock.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

51. What is your opinion of the legitimacy and/or advisability of the following proposal? Why?

"Stockholders of the F. G. Shattuck Co. have approved a reduction in the stated value of the capital stock to $15,152,000 from $19,975,000. The $4,823,000 surplus thus created to be used to write down good will to one dollar."
719. Dividends—Discussion and Comments.
720. Audit Program.

Review Questions.

719. Dividends—Discussion and Comments.—As in common parlance so in finance, a dividend is a thing divided. But more definitely stated, a dividend may be defined for our purposes as a distribution made by a corporation to its stockholders in proportion to their respective stockholdings. To distinguish between interest and dividends, it is sufficient to say that we speak of a bond bearing interest and a stock yielding dividends. That is, interest relates to bonds, whereas dividends relate to stocks. The essential difference between interest and dividends is, of course, that interest must be paid by a corporation whether or not profits have been earned, whereas dividends depend wholly upon the existence of profits legally available for distribution. Although this bald statement is subject to exceptions and to much elaboration, it is, nevertheless, the gist of the matter.

In the majority of cases, a dividend is paid in cash, but any other asset may be distributed. For example, if the American Manufacturing Corporation has $35,000 worth of bonds of Pacific Company, it may choose to distribute as dividends these Pacific Company bonds rather than pay out $35,000 in cash.

A second distinct method of liquidating a dividend liability is for the corporation to issue its own bonds, notes, or scrip. In doing so, the corporation simply replaces the dividend liability by a bond, note, or scrip liability, according to whichever type it issues. By way of explanation of the term scrip, it may be said that they are simply certificates giving the holder the particular rights stated within the certificate itself. Such a certificate may or may not bear interest, and may not have a definite maturity date.

A third type of distribution is through the issuing of capital stock. A stock dividend does not effect the net worth of the corporation as do the asset and liability distributions just mentioned above in cases one and two. All that really happens from the stockholders point of view is that after the dividend he holds more shares of stock which represent the same ownership and interest in the corporation as did the fewer shares of stock held prior to the dividend. For example, if B holds 500 shares of a corporation which has 1000 shares outstanding, B owns, popularly speaking, one-half of the business. If, now, a stock dividend of 100% were paid, B would then have a total of 1000 shares; but as there would be two thousand shares outstanding, it is clear that B would still own only one-half of the business.

So far, we have been speaking about dividends out of profits; but as there are also dividends out of capital, we must amplify this portion of the subject. Ordinarily, dividends come from profits, but whenever a corporation is winding up, or reducing its capital for one reason or another,

1A stock SPLIT-UP is different from a stock dividend. In the former there is NO change in surplus but there is an increase in the number of shares without any increase in the total par or stated values. Hence, the old shares must be exchanged for new ones UNLESS in the case of no-par stock there is no stated value (or if so, then not given on the certificate) and/or there is sufficient authorized stock available.

2Investment trusts should take up profits and absorb losses and dividends (other than stock) through the securities account, thereby solving the stock dividend problem.
a liquidating dividend out of capital is to be expected. That is, the capital or money invested in the corporation is returned, as distinct from a return of profits earned upon the capital. At this point I may as well note that the discussion is limited to dividends from profits.

Having classified the various types of dividends as to asset dividends, liability dividends, and stock dividends, and having drawn a distinction between dividends out of profits, and dividends out of capital, we are now able to take up the matter of the legality of dividends.

Subject to the particular corporation laws of each state, the following is generally true.

First, in case of a corporation with par value stock, the directors must not reduce the net worth (that is the difference between assets and liabilities) below the par value of the stock if it was issued at par or at a premium, or below the price paid in if it was issued at a discount. (Sometimes, however, it is legal if the stockholders and/or creditors agree.

Second, as to dividends of corporations with no-par-value common stock, there has been many court decisions on the point whereby one may say just what the common law is. Therefore, it has not seemed proper to attempt to set forth in a chapter of this size the many various views held by lawyers and accountants on this untried field. In a particular case, the auditor must observe the legal requirements of the corporation law of the state in which the client is incorporated.

To return then to the first point, it is to be noted that the general statement is that dividends must be paid out of profits and not out of capital. But even this needs considerable elaboration. For example, in England directors may pay out dividends to the extent of the profits of any particular year, whether or not there is an already existing deficit. This is permissible under English law because the directors are actually, as a matter of fact, paying the dividends out of profits and not out of capital. But in America, the general rule is that any existing deficit must be made good. In other words, in the United States only the credit balance of the surplus account (or accounts) is available for distribution. If the deficit is too great to be made up by retaining the annual profits, the directors can elect to apply to the state for permission to reduce the capitalization by the amount of the deficit. 3 From these statements it is clear that the United States rule is more conservative than the English rule, and that the purpose of it is to protect the rights of creditors who have made loans to the business on the faith that there would always be kept in the business an amount equal to the capital stock (or capital).

Although deficits must be made up, there is no necessity for writing off stock discounts in those states which permit stock to be issued at less than par value. 6 For example, if a corporation issues a fully paid $100 share of stock for $97, the $3 discount does not have to be made good out of profits before a dividend may be paid. The capital of the company is considered to be the par value of the stock less the discount; that is, the actual amount paid in, namely $97.

Upon the other hand, if $110 were to be paid into a corporation for a $100 par value stock, the premium of $10 is generally held to be available for dividends, in spite of the fact that it was paid in and not earned. To be certain, it seems rather queer that sums paid in by the stockholders may some day be paid back to them in the disguise of dividends or earnings; but it is nevertheless according to law. Be that as it may, it is clearly the ethical duty of the directors to state on dividend checks that so much represents a return of premiums, and so much represents earnings.

1 From an accounting point-of-view all that is paid in for the stock becomes capital unavailable for dividends even though part of it be called Surplus. Very often this is not definite. 3 Or other amount. 4 See end of Chapter, note #4. 5 Ibid.—note #5. 6 Ibid.—note #6.
Along this same line of thought is the problem of extraneous profits; that is, profits which do not arise from operations. For example, if a corporation were to sell at a profit some of the machinery it had been using, such profit is clearly extraneous. Although good accounting procedure requires that profits of this type must be stated separately from operating profits, nevertheless, the law generally permits their disbursement as dividends. But here again, the directors have a clear moral duty to inform the stockholders that such and such a portion of the dividend check is from extraneous profits, and such and such a portion is from earned operating profits. If it were not so, the directors, who are in a sense trustees of the stockholders, would be deceiving them as to the true power of THEIR corporation.

While dividends may be paid from realized extraneous profits, they may not be paid from unrealized sources; such as from the surplus from the appraisal of assets, or from anticipated profits on sales contracts. The American Malting case is a famous one on this last point. Here it was held by the court as follows: "These contracts were to deliver at a future time a product not yet made, from raw materials not yet purchased, with the aid of labor not yet expended. The price agreed to be paid at the future time had to cover all of the possible contingencies of the market in the meanwhile, and might show a profit, and ran a chance of showing a loss. You cannot make a dividend of a hope based upon an expectation."

A counterpart to the above is the fact that any drop in the market values of FIXED assets need not be taken into consideration in computing the amount of profits available for dividends. Suppose, for illustration, that a manufacturing corporation is using a piece of land costing $25,000 but which to-day because of a change in real estate values is conceded to be worth only $15,000. The law is that the $10,000 decrease in the market value of this FIXED asset, land, has no bearing upon the computation of the profits.

This rule does not apply, of course, to the current assets. Here the rule of cost or market, whichever the lower, should be applied.

In regard to a more or less prevalent belief that certain kinds of surplus can be used for stock dividends and not for cash dividends, it should be said that such a belief is a mistaken one. If a dividend is legally payable in one form, it is legally payable in any other form.

(It is admitted, however, that most authorities state that a dividend from surplus will always be legal if paid in stock, whereas it may be illegal if paid in any other form, such as cash.)

Still another point on which many persons go astray is in the belief that the size of the cash account determines the legal amount which is available for dividends. But the facts are that the legal amount of dividends available for distribution is determined by the size of the surplus account which, of course, has no connection whatever with the size of the cash account. To illustrate, if a corporation has earnings of $125,000, it may pay it all out in dividends despite the fact that it may have only $25,000 in cash. To be sure such a procedure may be unwise since it requires the corporation to borrow the money, but that fact simply involves a financial policy, not an illegal act.

In ascertaining the profits available for dividends, all losses and expenses must be included in the computation. But whenever a reasonably thorough attempt, such as would be expected if a prudent business man, has been made to figure the profits correctly, a dividend is not illegal because of subsequent developments.

1Stock dividends not excepted. See also Appendix C, Sec. 15-#9, and #10. 2Or other recognized and acceptable basis. Otherwise the law can be circumvented by issuing stock and retiring it soon thereafter with cash.
For instance, suppose the Jones Paper Company owed on account $23,000 to the B Corporation on December 31, 1929, and suppose that on the same date B Corporation paid out in dividends all of its profits, namely $107,000. If now, on March 7, 1930, the Jones Paper Company should fail to make good on its account, no one could properly maintain that the $107,000 dividend was illegal to the extent of this $23,000 loss. In brief then, losses cannot operate ex-post-facto to make a past dividend illegal.

Although (as just stated above) all losses and expenses including depreciation must generally be provided for in the computation of the net amount of surplus available for distribution, the same methods of computation do not always obtain in businesses subject to the depletion of natural resources. By depletion we of course mean the loss in value of an investment through using it up, as where oil is taken from wells, lumber from forests, ore from mines, and so on. In these cases, where the purpose of the corporation is to exploit a single project (not so with continuing projects) the profit and loss charge for the depletion of the oil, lumber, ore, or other natural resource, whatever it may be, is not legally required in computing the amount available for dividends. The law holds to the view that it is well known and understood that the profits of these businesses are partly true profits and partly capital. As long as a company pays its debts when due, the law presents no barriers against paying out dividends which are expedient from a business point of view even though they consist partly of profits and partly of capital (The dividend check should disclose each element.)

We shall now take up the concluding phase of this discussion which deals with the rights of stockholders.

Despite the popular impression, a stockholder hasn't an unconditional right to dividends even though profits have been earned. And this statement applies even to preferred stockholders; as well as to common stockholders. The facts are that the Board of Directors alone has the power to decide what dividends from the surplus are to be paid out to stockholders. To be sure, the stockholders may be able to oust the directors at the end of their term, but having elected them for such a term, generally one year, they, the directors, are in full power subject only to removal.

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1. In Wabash Railway Company v. Barclay (1929) 280 U.S. 197, the decision reversing Barclay v. Wabash Railway Company (1929) 30 F. (2d) 260, Mr. Justice Holmes delivered the opinion of the Supreme Court of the United States and said:

"We believe that it has been the common understanding of lawyers and business men that in the case of non-cumulative stock entitled only to a dividend if declared out of annual profits, if these profits are justifiably applied by the directors to capital improvements and no dividend is declared within the year, the claim for that year is gone and cannot be asserted at a later date. But recently doubts have been raised that seem to have affected the minds of the majority below. We suppose the ground for doubts is the probability that the directors will be tempted to abuse their power, in the usual case of a corporation controlled by the holders of the common stock. Their interest would lead them to apply earnings to improvement of the capital rather than to make avoidable payments of dividends which they may not share. But whether the remedies available in case of such a breach of duty are adequate or not, and apart from the fact that the control of the Wabash seems to have been in Class A, the case to which the plaintiff's belong, the law, as remarked by the dissenting Judge below, "has long advised them that their rights depend upon the judgment of men subject to just that possible bias."

"When a man buys stock instead of bonds he takes a greater risk in the business. No one suggests that he has a right to dividends if there
or correction by court order for gross misconduct, gross incompetency, gross mismanagement, and the like. The situation is similar to that of a President of the United States who cannot be immediately ousted because his veto displease those who have elected him, but he can be impeached. However, should a group of stockholders be unable to oust the directors at the annual stockholders meeting, nevertheless, they may have recourse to the courts who will hear their pleas on the illegal retention of profits. But as a matter

(Cont.) are no net earnings. But the investment presupposes that the business is to go on, and therefore even if there are not earnings, the holder of stock, preferred as well as common, is entitled to have a dividend declared only out of such part of them as can be applied to dividends consistently with a wise administration of a going concern. When as was the case here, the dividends in each fiscal year were declared to be non-cumulative and no net income could be so applied within the fiscal year referred to in the certificate, the right for that year was gone. If the right is extended further upon some conception of policy, it is enlarged beyond the meaning of the contract and the common and reasonable understanding of men.'

The court held that when the net profits of a corporation out of which a dividend might have been declared for the preferred stock are justifiably applied by the directors to capital improvements, the claim of the stock for that year is gone, if by the terms of the articles of incorporation and the preferred certificate, the dividends are not to be cumulative. The fact that there are profits in that year out of which dividends might have been (but were not) declared does not entitle such stock to a correspondingly greater preference over other stock when the profits of a later date are to be divided. However, the court did not decide that directors cannot pay dividends to holders of non-cumulative preferred stock for past years out of profits earned during those years nor did it expressly sanction distributions to common stockholders out of funds available on account of the failure to pay dividends on the preferred. This decision effectively puts a damper upon the hitherto growing tendency of the courts to uphold the claims of non-cumulative stockholders upon the theory of deferred credits." --L.L. Briggs

"In short, the English rule in respect to dividends on non-cumulative preferred stock is that the earnings of each year are distributed without regard to the situation in prior years, and there is no right to accumulate past, earned, but withheld dividends. In effect, it denies any discretion in the directors to withhold dividends when there are profits for the year. Preferred shareholders' earnings may never be used as increased capital for the corporate enterprise." --L.L. Briggs.

"In conclusion it may be said that the dividend status of non-cumulative preferred stock is settled so far as the federal courts and the state courts adopting the federal view are concerned. If a statute, charter, or by-law is to the effect that a dividend is absolutely due upon the happening of some specified event, as the earning of profits, the directors have no alternative, but must declare a dividend according to the terms of such statute, charter, or by-law. In all other cases, when there are sufficient profits, the directors may exercise their discretion. If they declare dividends out of the current profits, the non-cumulative preferred stockholders are entitled to a preference for that year only. If the directors act in good faith for the best interest of the corporation, they may use the earnings of any fiscal period for improvements and additions to the business and/or the increase of working capital and pass the non-cumulative preferred dividend which otherwise might have been declared and paid. The claim of the preferred shareholders to the earnings of that year is gone and cannot be asserted at a later date." --L.L. Briggs.

1 Or other actions or measures. 2 For a certain few causes such as conspiracy with foreign governments, etc.
of record, it is found that courts demand a very clear cut case of fraud or
mismanagement, or the like, before they, the courts, will set aside the
actions of a board of directors.

After a dividend has been declared, it may not be rescinded if the
declaration has been made public, except that an illegal dividend may be rescinded.

The weight of authority as expressed in American decisions seems to indi-
cate that, when the balance sheet shows a surplus, a dividend may be declared
and that when it does not show a surplus a dividend can not be declared. The
weight of authority also seems to indicate that the surplus of the balance
sheet means the figure which represents the excess value of the assets on the
date of the dividend, over the amount of the liabilities plus the capital;
and that the capital here means the amount actually received for the stock
issued whether at par or less than par" (but not when issued at more than par
for here the premium becomes surplus available for dividends according to
common law but not according to recognized accounting procedure).--

The English courts have held almost without exception to the opinion that
the profit-and-loss account, for the current year shows whether or not a divi-
dend shall be declared. If there is a profit for the year, no attention need
be paid to losses of capital of a prior period, nor the losses of fixed capi-
tal of the present period."--C. F. Schlatter, ibidem.

In McLaren v. Crescent Planning Mill (1906) 117 Mo. App. 40 the court de-
cided that the more declaration of a dividend by a solvent corporation does
create a debt in favor of the stockholders even though a fund has not been
set aside. (Adapted from L.L. Briggs)

In Beers v. Bridgeport Spring Company (1875) 42 Conn. 17 the court de-
cided that where dividends have been declared payable at the will of the
directors, the latter can not repudiate its obligations either by refusing
to pay the dividends or to set the dates when they are payable. (Adapted
from L.L. Briggs)

It has been held that without a court order a corporation can not take
a dividend in payment of a debt or as an off-set to an assessment levied to
cancel the dividend. (Adapted from L.L. Briggs)

In Le Ray v. Globe Insurance Company (1836) 2 Edw. Ch. (N.Y.) 657 the
court decided that the "Insolvency of the corporation occurring before pay-
ment made no difference in the obligation of the company to carry out its
dividend declaration and gave the concern no right to rescind the unpaid
dividend debt. Although no money was specifically set apart to meet the
(signed) checks, the court looked upon the amount of the unpaid dividend
as a trust fund to which the stockholders had acquired vested rights as
individuals. "--L.L. Briggs.

In Ford v. Easthampton Rubber Thread Company (1893) 158 Mass. 84, the
court said in regard to a rescinded declaration: "It does not appear that
any of the stockholders, except the directors, knew of the original vote, or
that any of the stockholders had made any contracts, incurred any liability,
or done anything relying on the vote. It also appears that no fund was
distinctly set apart for the payment of the dividend before the vote was
rescinded. ....... it was (therefore) within the power of the directors,
at a meeting subsequent to that which the vote was passed, to rescind it."--

In Benas v. Title Guaranty Trust Company (1924) 216 Mo. App. 53 decided
that "The ultra vires declaration of a dividend, the distribution of which
would impair capital, may be reconsidered and rescinded."--L.L. Briggs.

In Lexington Life, Fire and Marine Insurance Company v. Page (1856) 56
Ky. 412, the court held that "If a dividend has been declared when there
was no surplus, it may be rescinded by the corporation (and reclaimed) even
though the stockholders have received the distribution."--L.L. Briggs.
at all times, even to the extent of following the money into the hands of the stockholders. Unpaid dividends rank as an ordinary outside liability so that in case of insolvency, the stockholders would share pro rata with other creditors of the same unsecured rank. But this rule is void if the corporation was insolvent when the dividend was declared, or if the dividend made the corporation insolvent. On the other hand, if a corporation, having legally set aside a current dividend fund, should become insolvent, the fund is not subject to seizure by the other creditors because the law considers it to be a trust fund for the stockholders. (A stock dividend may be rescinded up to the time of the issuance of the stock).

720. Audit—Program—

(1) Check the dividends declared against the authorizations in the minutes of the Board of Directors.
(2) Ascertain the status of the dividends on the preferred stocks.
(3) Ascertain if any dividends have been declared but not recorded at the audit date.
(4) Check dividend lists to stock records, foot, and check against the amount of dividends paid.
(5) Verify bank accounts if the dividends are set aside in a special fund. Set up the balance of the funds and the liability for the unpaid dividend checks.

1In Wilson Company v. Matthews Brothers Manufacturing Company (1916) 164 Wis. 152 the court held that "a cash dividend declaration may be rescinded before payment if the consent of all the stockholders is obtained or if the stockholders act in a manner as to estop them from denying the validity of the rescission."—L.L.Briggs.
2"The general rule is that such a declaration (stock dividend) may be rescinded at any time prior to the actual issuance of the stock"—L.L.Briggs. This is because a stock dividend is "a mere nominal right" possessing "no appreciable pecuniary value"; whereas "a cash dividend entitles the stockholder to so much money, the ordinary way in which he receives from time to time the fruits of his investment. Such dividends do not materially affect the value of the stock."—Perry v. Eagle Lock Company (1879) 47 Conn. 141.
3In Hollingshead v. Woodward (1885) 35 N. Y. 410, the court "recognized the legality of the rescission in spite of the fact that the stock had been issued."—L.L.Briggs.
4In Dock v. Schlicter Jute Cordage Company (1895) 167 Pa. 370 the court decided that except "under unusual circumstances of necessity such as destruction of plant by fire immediately following the declaration", a dividend in treasury stock, purchased with earnings, can not be rescinded as "the principle governing the rescission of cash dividends applies."—Adapted from L.L.Briggs.
5In those states which do not permit par value stock to be issued below par, the transaction is illegal. Furthermore, the discount is undoubtedly a receivable due from the stockholders and/or the directors. Finally, in Handley v. Stutz (190 U. S. 417) the Supreme Court held that when a corporation (because of its poor condition) can not sell its stock for par, the discount may never be collected from these new stockholders — even by creditors. Each such exception as this, however, must be decided upon its own merits. It is not a general rule.
6It may also be interjected here that courts have held that a business was insolvent when it had an inverse current ratio, or when it was unable to meet its maturing debts.
(6) Inquire into the legitimacy of the dividend declarations.
(7) Investigate dividends paid in capital stock, scrip, bonds payable, or property other than cash.
(8) Ascertain the method of paying dividends in corporations operating wasting assets.

REVIEWS QUESTIONS

1. Give an illustration of an unrealized profit. May a dividend be paid out of this profit?
2. Give an illustration of an anticipated profit. May a dividend be paid out of this profit?
3. Give an illustration of an extraneous profit. May a dividend be paid out of this profit?
4. Must the Stock Discount account be written off before dividends are paid?
5. Does a drop in the market value of fixed assets have to be taken into consideration in computing the amount available for dividends?
6. What is the rule in respect to current assets?
7. Is it possible for a dividend to be legal if paid in capital stock but illegal if paid in any other form?
8. State the general rule in regard to the payment of dividends.
10. What are a stockholder's rights in respect to demanding a dividend?
12. What special dividend rule is applicable to businesses which are subject to depletion?
13. Wherein is English dividend practice different from American practice?
14. When may dividends be properly paid out of capital?
15. What is the general dividend rule when the stock is no-par-value stock?
16. Are premiums received on capital stock legally available for dividends?
17. Name various ways in which a dividend liability may be liquidated?
18. What is the verdict of accounting theory in regard to question 16?
19. When may a dividend declaration be rescinded?
20. What are the advantages or disadvantages to the stockholder of each of the ways given in your answer to #17? To the corporation?
21. At what value should a stock dividend of no-par-value capital stock be charged to SURPLUS?
22. What rights have non-cumulative preferred stockholders when profits have been earned but no dividends have been declared?
23. How should dividends paid out of capital be recorded on the stockholder's books?
24. What are the rights of stockholders of an insolvent corporation to a dividend fund which has been set aside for them?

25. Give two auditing procedures not given in section 720.

26. What is your opinion of the following Ohio law? Why?

8623–37 Every corporation subject to this act shall have and shall carry upon its books a stated capital, which shall be an amount not less than $500, except as otherwise provided in respect of consolidated corporations, shall be equal to

(1) the aggregate par value of outstanding shares having par value, including therein treasury shares, plus

(2) the aggregate amount of consideration received for its outstanding shares without par value, including therein treasury shares, except such portion of such consideration as shall have been expressly received and applied by the corporation as paid-in surplus; or if the shares without par value have been substituted for shares with par value, the aggregate amount of consideration received for such shares without par value shall be deemed to be the amount of the par value of the shares for which they were substituted, unless at the time of such substitution the stated capital of the corporation was reduced by appropriate proceedings, plus

(3) Such amount as may be transferred from surplus to stated capital upon the declaration of a share dividend, plus

(4) In the case of a corporation having shares without par value, such amount as may be transferred from surplus to stated capital.

8623–38 See chapter 44 section 682.

27. On the basis of the following legal quotation, it has been stated that cash dividends may be paid out of appreciation surplus. What is your opinion? Why?

Surplus is "what remains after deducting from the present value of all the assets of a corporation the amount of all liabilities, including the capital stock."¹

¹14 C.J. 802 Dec. 1215
CHAPTER 45
COMMENTS ON
OPERATING ACCOUNTS
AND
DETAILED AUDITS

723. Interest. 724. Insurance Expense.
725. Payrolls. 726. Legal Expense.
741. Income from Sales Awaiting. 742. Primary Records.
Future Delivery. 743. Examination of Vouchers.
748. Inter-company or Departmental Profits. 749. The Sales Book.
752. Frauds in Inventories. 755. Verification of Footings & Postings.
754. Ticking, etc. 756. The Trial Balance.
758. Returned Purchases and Allowances. 759. Agent's Reports.
760. Inventory Ledgers. 761. Deferred Income.
762. Explanation of Plate 234. PLATE 234--An Audit Program.

Review Questions.

721. Introductory Comment.--The subject matter included in this chapter is but fragmentary of the procedures to be taken in a detailed audit inasmuch as most of the ground has already been covered hereinbefore. This was done in the belief that it is better to allow the instructor to indicate what would likely be done on a balance sheet audit, on a detailed audit, on a cash audit, and so on, than for the writer to attempt to make the distinctions.

722. Organization Expense.--If the ORGANIZATION EXPENSE account has not been "watered", there is no necessity for writing it off rapidly. However, the account has fallen generally into such bad repute, because of flagrant manipulations, that even conservatively capitalized corporations deem it advisable to write the account off as rapidly as profits will permit.

The best practice is to charge the write-off to the AMORTIZATION OF ORGANIZATION EXPENSE account (or similar title), which is suitable placed in the profit and loss statement under the major caption of NON-OPERATING LOSS AND EXPENSE (see section 635).³

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1 See also Chapter 49, section 636.
2 Theoretically, the account should be expensed proportionally over the entire life of the business. Obviously, the number of years that the business will exist is usually unknown; hence the arbitrary lump-sum write-offs.
3 It can properly be charged to SURPLUS, too.
723. Interest.--Except in the case of special audits, such as those undertaken for investment bankers about to float a bond or note issue etc., for the client, both the Interest Income and the Interest Expense accounts are analyzed CHIEFLY for the purpose of revealing fraud, undisclosed assets and liabilities, non-taxable items, for checking the accuracy of the interest bearing asset and liability accounts already audited by direct methods, and so on.

724. Insurance Expense.--The chief purpose of analyzing the various insurance accounts is not to make certain that all expense has been included, although this is important, but to see that all policies have been presented to the auditor for examination so that he may determine (1) that there is a proper distribution of coverage (2) that no unrecorded loans have been made on life insurance policies (3) that no unknown policies have been pledged thereby revealing, perhaps, undisclosed liens and/or liabilities, etc.

725. Payrolls.--Some comments on payrolls were made in section 107. It is pointed out in connection with the ascertainment of the accrued current liabilities that a rough approximation of the payroll as at the audit date is often sufficiently accurate. Furthermore, at this time it needs to be brought to the forefront that it is the salary accruals which are most often overlooked, including special bonuses which, although not yet formally voted upon and/or accurately computed, are nevertheless reasonable certainties. Sometimes, however, there is a definite contract between the client and its managers or other employees, but the agreement itself is vague as to the method of computing the extra compensation, such as, for example, whether or not this sum is to be considered as an expense itself or as a division of the profit.

726. Legal Expense.--The LEGAL EXPENSE account should be analyzed not so much for the purpose of ascertaining if all legal expenses have apparently been taken up, as for ascertaining what were the causes for these expenditures. Of course, as the vouchers themselves may not give a hint of the nature of the legal services rendered, it is incumbent on the senior auditor to secure the information from the officials or lawyers direct, including a statement that all legal expenses incurred but pending have been accrued on the books of account. Having ascertained what the legal services were for, the auditor must determine, by reflection and by conference with the client's officers, what direct and/or contingent liabilities, etc., must be set up or footnoted on the balance sheet in order to give an unqualified certificate. It is the skill and judgment that is displayed in such instances as those that constitutes auditing as distinct from the layman's idea of it; i.e. as footing and checking books for the purpose of detecting fraud and clerical errors.

1 If there is a system of internal check, the auditor must see if it is WORKING, for too many businesses have such a system "on paper" only.
727. Advertising.—When the prepaid advertising consists of supplies, gifts, catalogues, etc., as well as for advertising yet to appear in print, the auditor's chief concern should be to see that the inventory stock is FRESH and CURRENTLY usable. Very often the auditor finds that the catalogues, for example, are out of date, or are in such large quantities that they will be out of date long before they can be distributed.

One of the most difficult problems encountered in connection with properly setting forth the advertising accounts is met when the deferred charge is found to be an estimate of the advantages which the future period will reap from the advertising which has ALREADY appeared in print, on billboards, over the radio, and so on. It is quite apparent that the benefits of a large advertising campaign which has been conducted during November and December, for example, will extend into the succeeding period. BUT the perplexing question is HOW MUCH benefit? No rule of thumb can ever be stated; sound judgment applied to the individual particulars of the specific case is required. But, on the other hand, THERE IS a decided weight of opinion that the amount so determined is an OTHER ASSET (Deferred Charge to Operations), NOT A PREPAID ASSET.

728. Salesmen's Traveling Expense.—To just what extent the auditor should attempt to see that these expenses are bona fide, such as by checking reported mileage payments against actual distances traveled, as stated by the salesmen in connection with certain other independent reports, is a problem that should be taken up with the client PRIOR to undertaking the detail audit. Some concerns allow their salesmen a very wide latitude as to what they may include in their expense reports, even to the point of winking at considerable padding, if only the business is gotten, whereas other clients require a strict accounting of all expenditures.

In either case, however, the auditor must make a point of accruing the expenses of the current period, as stated in the salesmen's reports handed in along the first of the SUBSEQUENT period, together with an adjustment of the overlapping as at the beginning of the period, PROVIDED the sums involved are worth correcting. In a balance sheet audit the sums omitted should be compared with the amount of the total current liability; but in a profit and loss audit, the comparison should also be made with the amount of the expense account to which the omission relates, and to the net profit. Thus in a balance sheet audit, a ¥4,000 liability may be omitted without appreciable error if the total current liabilities are, say ¥1,600,000. BUT if a profit and loss audit is also being made as well, and the ¥4,000 relates to an account whose present unadjusted total is ¥10,000, there is more reason for taking up the adjustment. Furthermore, the ratio of the ¥4,000 to the final net profit will ordinarily be sizable.

729. Freight.—The student should realize that the FREIGHT account is one of the most abused accounts. Thus freight paid upon machinery purchased is chargeable to the MACHINERY account; freight paid on samples sent out to customers is a selling expense; freight prepaid on a shipment for the convenience of a customer is chargeable to the customer; freight paid on salesmen's display cases is a selling expense, etc. In short, the two commonly used FREIGHT-IN and FREIGHT-OUT accounts are entirely inadequate to analyze the multiplicity of freight charges to be found in a large business.

Again, it must not be forgotten that freight must often be added to the invoice price of a commodity in arriving at its correct inventory value. Thus coal may cost ¥2.50 a ton f.o.b. at the mine and cost at least an additional ¥2.50 a ton to have it hauled to the plant. So also, commodities
purchased in foreign countries, f.o.b. point of purchase, should be valued, when at the client's place of business, at the invoice price, insurance cost, duty cost, freight cost, and similar costs.

In respect to examining the freight bills for possible overcharges by the carriers, the auditor should do but little, if anything. It is not his function to see that the proper rates have been charged by the carriers. His duty is to see that the invoices have passed through the regular accounting routine of the client, as evidenced by the approval signatures of the various clerks, plus some inquiry into the correctness of the distribution among such accounts as have been mentioned above.

In a cost system the freight-in is usually combined (often very arbitrarily) with the invoice cost of the article, before entering it on the perpetual inventory cards. Accordingly, the final inventories will include a charge for freight. When no cost system is kept, it is not customary (though perfectly correct) to defer as an asset the estimated portion of the freight applicable to the inventories.

If the sales price includes the cost of shipping, the FREIGHT-ON-SALES account should be handled as a deduction from sales. If, however, this item represents a favor granted to certain special customers, its cost is a selling expense.

730. Profit and Loss Account.—When properly used, the PROFIT AND LOSS account is merely a summary closing account into which the various profit and loss accounts are closed out. That is, no charges or credits should be made direct to the PROFIT AND LOSS account during the period, but rather to some clearly labelled account descriptive of the item (transaction) involved. Thus any gain or loss arising from a sale of securities should be credited or debited to the Gains and Losses on Sales of Securities account — NOT to the Profit and Loss account. Finally, the balance of the Profit and Loss account will be closed into Surplus (corporation) or into the Capital or DRAWING account (single proprietorship) or accounts (partnership), according to the type or organization.

731. Returned Sales.—Although the figure for the returned sales is rarely ever wholly applicable to the sales of the current period, no attempt is ordinarily made to separate out the returned sales which were the actual sales of the prior period, because the overappings from one period to another generally balance out fairly well. In some rare instances it may be advisable to charge the returns related to a prior period to INVENTORY and SURPLUS; or even to make a provision, as at the audit date, for the "returned sales" as yet unreturned.

If the following adjustment is made, the current returned sales, which represent sales of the prior period, should be charged against the Provision for Expected Returned Sales account.
Dec. 31  Expected Returned Sales\(^1\)  
Provision for Expected Returned Sales\(^1\)  
Inventory  
Cost of Goods Sold  
Jan. 24  
Provision for Expected Returned Sales  
Accounts Receivable  

At the end of the next year the balance of the Provision for Expected Returned Sales account must be adjusted through the inventory and surplus accounts before the new current provision is set up.

Of course, where a perpetual inventory of finished goods is maintained, it is easy to deduct the gross profit on the sales returned, seeing that the goods go back into the stock records at cost.

| Surplus | 150,000 |
| Finished Goods | 500,000 |
| Accounts Receivable\(^2\) | 650,000 |

Ordinarily, however, sufficient accuracy is secured by the following usual entries.

| Finished Goods | 16.17 |
| Cost of Sales | 16.17 |
| Returned Sales | 20.50 |
| Accounts Receivable | 20.50 |

Finally, it may be noted that "the size of the returns is an index of efficiency or inefficiency in filling orders, shipping exact goods called for, shipping within reasonable time, quality of goods and packing of goods.\(^3\)

732. Consignments.—In this section attention will again be called to the quite obvious fact that neither consignments-out nor shipments to branches are sales. Only recently, however, it appears that a certain manufacturer of shaving blades showed substantial profits on this sort of inflated basis.

In auditing this account, or its equivalents, the auditor should compare this period's list of consignees with that for the prior period with an eye open for omissions from the current list. Moreover, he should verify these inventories by independent confirmations with the respective consignees.

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\(^1\)A deduction from Accounts Receivable.

\(^2\)Assuming no adjustment is made as at the audit date for expected returned Sales.

\(^3\)Bennett, p.216.
On the other hand, CONSIGNMENTS-IN must be inventoried, but OMITTED from the final inventory figures. When this is done and the amounts are confirmed by the auditor by direct correspondence with the consignors, the auditor is then reasonably assured that sales of these goods have not been credited to Sales but to liability accounts, such as "Due to Co. K on Consignment Sales". No amount of test checking can take the place of these two direct and simple audit procedures in ascertaining that the consignments-in have been properly accounted for.

It may be pointed out here that another duty of the auditor's should be to see that all commissions due have been taken up, and that all of the consignees have rendered ACCOUNT SALES up-to-date, or vice-versa if the client is a consignee.

Consignment merchandise itself should always be marked, if it is not distinguishable from the merchandise of others, in order that it may be regained in case the consignee becomes bankrupt. In many instances the auditor should also make certain that the consignee is keeping the client's funds separate from his own, if such care is provided for in the contract between these two parties. If there is no such provision, the auditor should consider the appropriateness of making such a suggestion to his client.

If the consignments are in foreign countries, the auditor must make certain that the goods can and ARE being sold. If not, their inventory value may be practically nil, for it is often inadvisable to pay the cost of return freight, etc.

732. Appreciation of Assets.—See section 628.

734. Bad Debts.—The auditor should never be lulled to sleep by the SUPPOSED efficacy and accuracy which various mathematical calculations of the allowance for bad debt expense, such as a certain per cent of sales for example, seem to connote. The amount so determined should always be critically examined against the amount of bad debts written off in prior periods, and to see if current conditions, such as a universal business depression for example, do not demand a somewhat larger allowance.

In the writer's opinion, the various percent methods should be used only when the number of the accounts run into the hundreds and the individual balances thereof are small. Where the number of accounts is smaller than this, or where there are any accounts with large balances, the auditor should review the accounts individually with the credit and collection manager (or similar official) i.e., those accounts which need this mutual review and criticism in order to evaluate them properly. Finally, the auditor must not forget that after an allowance is made for each of the doubtful accounts, some additional blanket allowance should be made for those account balances which are at present current but out of which bad debts will most assuredly arise.

Except when the amounts are large, any write-off of an account which arise in a prior period, and for which no allowance (either specific or blanket) has been provided, should be charged to BAD DEBT EXPENSE in preference to SURPLUS. The same procedure is applicable whenever the SPECIFIC allowance

1Also do not forget the notes on hand, and the notes and accounts under discount
2If desired, these adjustments can be charged to "Bad Debts of Prior Periods."
3Theory gives way to the desirability of getting into the profit and loss statements as many charges as is possible; otherwise these overlapping corrections are apt to be overlooked in judging the success (income) of the business on the basis of the published yearly statements.
proves too small to cover the loss, when it is finally determined. (Some auditors charge the loss in full to the RESERVE FOR BAD DEBTS account on the assumption that during the period other losses will occur which will be less than the allowance set aside for them). Bad debts representing sales of the current period should be charged DIRECT to BAD DEBT EXPENSE. If not, the year end blanket provision will simply be that much larger than otherwise.

In all cases the auditor should satisfy himself that the bad debts which have been written off have received the sanction of the responsible officers. This assurance can best be secured by getting the signatures of these men on the auditor's working paper which gives the names and amounts of the accounts written off during the audit period. In many instances the auditor will deem it advisable to embody this list in his Auditor's Report. Finally, it should be pointed out that the auditor should be on guard to see that the bookkeeper has not added additional names to the Journal Voucher (or other list) after it has been signed and thereby approved by a "high official". The correct procedure for the auditor to follow, in order to catch any manipulations, or unintentional errors of whatever sort, is to audit the JOURNAL from the duplicate Journal Vouchers which were kept by the "high official(s)" who gave his (their) approval(s).

Bad debts recoveries of small amount may be credited either to BAD DEBT EXPENSE or to the RESERVE FOR BAD DEBTS, or to BAD DEBT RECOVERIES; otherwise they should be credited either to the latter account or to SURPLUS.

Certain "bad debts", still open to possible collection, should be taken up in a special Ledger even though written off the Sales and General Ledgers. Persistent collection methods generally yield a substantial net profit over costs of collection.

If no collection and credit manager exists, the auditor should consider the advisability of suggesting that one be appointed, or that this function be recognized and assigned as one of the responsible duties of one of the client's present staff.

The BAD DEBT EXPENSE account should usually be treated as a selling, administrative or financial expense, according to who (sales manager, office manager, or treasurer) has charge of the credits and collections. In this way the expense will be listed in the proper section of the Profit and Loss Statement controlled by these men respectively. On certain theoretical grounds, bad debt expense is not an expense but a deduction from sales. If so recorded, the cost of goods sold, and each expense account will have to be credited to relieve them of costs of making these sales, the debit being the true bad debt expense. The practical application of these refinements leads one into a maze of unsurmountable difficulties.

735. Auditing the Profit and Loss Statement.---On the occasion of a first detailed audit, it will be necessary, if no previous balance sheet audit has been made, to establish a prior authenticated position. It is not sufficient for the auditor to audit the current profit and loss statement and the current balance sheet. The correct balance sheet as at the beginning of the period must be ascertained. For example, it is impossible to say that the current depreciation expense of machinery is correct unless it is definitely known that the opening balance of the MACHINERY account is correct. Again, as the balance of the ADVERTISING EXPENSE account is composed of the opening

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1 This is feasible if the differences are small.
2 I.E. where the specific allowance method is used.
3 This account falls under the profit and loss statement caption, NON-OPERATING GAINS and INCOME.
balance (the prepaid amount as at the beginning of the period) and the
current expense vouchers less the prepaid amount at the end, it is obviously
necessary for the auditor to determine the accuracy of the prepaid amount at
the beginning of the period in order to be assured that the current expense
is accurately stated.

On a balance sheet audit the auditor must not overlook the fact
that the Profit and Loss account is a balance sheet item.

Finally, it must be clearly recognized that this statement is
becoming more important than the balance sheet even to the general public.

736. Income and Expense Prior to Commencement of Operations.—
Prior to the commencement of operations, there is neither income nor expense.
Thus the wear and tear on a building, both by the workmen and by the elements,
before it is put into use, is not computed and charged to expense, because an
expense is a cost of producing the revenue,—of which there is none as yet.
Moreover, this procedure is a common-sense one. Again, if money is borrowed
by the client to finance a construction program, the interest cost thereof
should be capitalized (assuming that the above definition of an expense is
correct). Furthermore, the cost of the project will not thereby be "watered"1
for assuredly a contractor in quoting his price to the client (who in this case
is doing the construction under its own auspices) would take into consideration
the interest charges which he must incur if he borrows the funds, or which he
must lose if he has the money himself.

As to the propriety of capitalizing mistakes and errors, etc., made
prior to commencing operations, it seems clear to the writer that certain of
them may be charged temporarily to asset accounts, preferably to an account
falling under the classification of a DEFERRED CHARGE TO OPERATIONS, whereas
others of them must just as certainly be regarded as losses. Thus if a single
or small group of machines is lined up, and then torn down and relined in a
different position, for example, the cost (if large) of this rearrangement
should be charged to some properly named deferred charge account "not to
MACHINERY) to be written off as rapidly as is possible" on the basis that
some such mistakes are ALMOST inherent in the undertaking.

On the other hand, if a building in process of completion should cave in or
be blown in, there is a LOSS — NOT a deferred charge.

So also, the surplus profits of a purchased business cannot be taken
up by the purchasing concern. But if a business is purchased on one date and
is not actually transferred for several months later, say, the profit earned
by the purchased business during this interim period may be taken up by the
vendee. In short, under normal circumstances a business will have neither a
surplus nor a deficit before it commences operations.

737. Capital v. Income.—The accuracy of the profit and loss state-
ment, as well as that of the balance sheet, is dependent on a very large

1. In fact the client is undertaking the project to cut down the cost, i.e.
   the contractor's profit.
2. This should not be regarded as the sanctioning of capitalizing losses.
3. "It must be admitted that losses which occur during operation, like pre-
   liminary losses, are not always easy to recognize. The distinction between
   asset balances and losses, and between expenses and losses, is sometimes not
   clear. Business operation, it must be recognized, is not carried on under ideal
   conditions. Inefficient laborers are hired. Are the resulting wages a loss?
   Goods are carelessly packed and are returned by the customer, damaged. Is the
   amount of the damage a loss or an expense? Maintenance charges are heavy be-
   cause new men are handling the machines. Is the excess over a normal amount a
   loss? As a practical matter it is probable most reasonable to assume that all
   current expirations which arise under circumstances which are not thoroughly
   abnormal are costs of producing revenue."—Paton (p. 559)
degree upon the proper determination of the capital and the revenue charges. Practically everyone admits that from the point of practical procedure it is better to err on the side of conservatism by charging doubtful items to expense than it is to charge expense items to asset accounts. Furthermore, the theory of the principle involved must not be pushed to ridiculous refinement as when, a ¼ 25 door in an office building, for example, is replaced by a ¾ 30 door. Actually there is a ¾ 5 betterment which should theoretically be capitalized, but from a practical point of view it is too refined and too costly to ascertain or estimate the cost of the old door, and the accrued depreciation thereon. Certainly, the auditor should never attempt to adjust such items, seeing that the procedure is a salutary conservative policy. Indeed many organizations have established a minimum capital amount, all items falling below which must be expensed irrespective of the fact that they could properly be capitalized from a theoretical viewpoint.

738. Maintenance Accounts.--Even in a balance sheet audit, the maintenance accounts should receive some attention lest capital assets be erroneously expensed. Hence, in a detailed audit, the auditor will sometimes make but little further verification of these accounts.

In ascertaining the appropriateness of the depreciation charges, the auditor should always make constant reference to the amounts being expensed via the maintenance accounts. Indeed, it is often advisable to present in the Auditor's Report a table showing the repair and the depreciation charges, including percentage calculations. See chapter 53.

739. Accruals.--In a business of some magnitude, there will always be certain expense items arising in the current period which apply to the prior period, and yet which reasonable test, scrutiny and reflection as at the prior audit date, failed to uncover. This is particularly true when the auditing is finished shortly after the audit date.

Although theoretical accuracy requires these items to be charged to SURPLUS, the common sense method is to allow them as current expense, seeing that in all likelihood there will be some unavoidable omissions from the current accounts as at the end of the current audit date. If these sums, which are applicable to a prior period, are large, it is advisable to deduct them in the NON-OPERATIVE LOSS and EXPENSE section of the profit and loss statement in preference to entering them as charges to SURPLUS; for, one must realize that insofar as the published accounts are concerned, these charges are quite likely to disappear altogether, unless the business is committed to the policy of publishing an ANALYSIS OF SURPLUS schedule. Even then, insofar as the average person is concerned the damage of the prior incorrect statements is not repaired; only the repair materials are supplied.

In this connection it may be well to emphasize that although small "overlapping" are of no consequence to the auditor, he must never give that impression to the bookkeepers. As for them, small omissions should be called to their attention, because it is only by such ceaseless effort on the auditor's part to get the bookkeepers to take up all accruals within

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1. This policy of the auditor's is obviously not applicable to the client's chief accountant.
the correct period that only minor items escape the "drag-net". If the bookkeepers are not called to account for these omissions, the auditor is apt to find that the expense accounts will be closed before every reasonable effort has been made to take up elusive expense accruals.

740. Income from Work-in-Progress.-- See Appendix C, Sec. 20.
See also Chapter 17, Sec. 276.

741. Income from Sales Awaiting Future Delivery.-- In the above section there is stated the very conservative practice of not taking up the profit on goods sold but on hand ready for delivery. In the writer's opinion, an auditor cannot always substantiate this practice unless the client has a clear cut record of having accepted numerous cancellations in the past. Indeed, it is believed that the current practice of leading auditing firms is to allow the profit on certain such transactions, especially if the goods are "packed and separated from the mass". All such sales should be verified by direct correspondence unless paid for.

On the other hand, outright attempts at window dressing by the inclusion of every possible (and impossible) iota of profit should be vigorously frowned upon. Obviously, every odd-and-end of expense has not been recorded.

742. Primary Records.-- Once again, it is found to be necessary to stress the importance of such primary records as the Shipping Record, the Receiving Record, the Requisition Book, the salesman's Order Book, the In-and-Out-Clock Cards, and other similar auxiliary of primary data not ordinarily considered to be a part of the accounting records. By the use of these records the auditor can establish not only the apparent genuineness of the entries in the accounting books of original entry, but also the proper "break-off" between each fiscal period. Thus false entries in the Sales Book have often been detected because the Shipping Record did not show any corresponding shipments of goods. Of course, it is quite likely, but not always a certainty, that a proper circulation of the accounts receivable (which procedure is unusual) would uncover this sort of fraud. Likewise, innumerable instances of both unintentional and intentional overlapping of sales have been found by using the Shipping Record in conjunction with the Sales Book, and/or the salesman's Order Book, and/or Unfilled Orders book.

Other cases illustrating the use which is made of auxiliary and primary data in substantiating the books of account in respect to fraud and/or unintentional omissions and/or commissions, might be continued at length, but it is believed that the above examples are ample to illustrate the proposition.

1. If large.
2. The use of primary data was emphasized in connection with auditing for liabilities, genuineness of accounts receivable, overlapping of sales, etc.
3. If the fictitious sales were charged to a relative or to a confederate, for example, circularization would not reveal this inflation of accounts receivable.
4. The purchasing agent's records of goods ordered but not received are often invaluable, especially in connection with commitments.
743. Examination of Vouchers.--See Appendix C. sec. 21. See also Chapter 10, sec. 124.

744. The Purchase Book.--In a strict balance sheet audit, the auditor's attention will be confined solely to the last few days of the audit and to the first few days of the subsequent period, in order to ascertain among other things that all liabilities have been taken up and in the proper period, etc. But in a detail audit, the purchase records will very likely be vouched for several months,\(^1\) the number of months depending upon the desires to the client, or upon the requirements of the engagement as based upon the facts to be certified, etc.

At this point the student should re-read sections 117 and 118.

"If fraud exists in connection with purchases, it is usually found in the form of overcharges or fictitious vendors. Very seldom if ever is there any concealment of fraud through manipulations of footings or postings.\(^2\) Therefore, only a few pages need to be footed, in addition to the last page of each month. The latter should be footed and CROSSED, because experience shows this to be the page most commonly tampered with. As to fictitious vendors, and the like, the auditor's chief protection against it is by test checking the Purchase Record against the Receiving Record, purchasing agent's Order Book, and other similar auxiliary and primary data.

Finally, attention must again be drawn to the fact that the auditor's primary duty is to see that such system of internal check as the client professes to have is ACTUALLY WORKING. For example, are the checks to be signed by the treasurer accompanied by the "approved" vouchers to which they relate, or are the checks signed haphazardly without reference thereto?

745. Testing the Revenue and Expense Accounts.--On a balance sheet audit, the auditor should ascertain carefully just what kind of test checks can be devised for testing the revenue and the expense accounts, for, unless the results of operations appear to be correct when thus tested, it is not advisable for him to assume that the balance sheet is correct. Thus is it known that all merchandise is marked up at least 60\% on the selling price, a gross profit of 50\%, as per the profit and loss statement, should attract the auditor's attention. Again, if the books show an overhead of a certain per cent of the direct labor, whereas the cost department is using another radically different per cent, the auditor should ascertain the whys and wherefores. Again, a two-year comparison should be made between all profit and loss items, especially a per cent comparison, so that accounts which vary considerably may be analysed to determine the cause of the increase or decrease. Thus, if the Sales have increased 10\% for the current period, salesmen's commissions MAY be expected to be larger, but only about 10\% larger at most. Therefore, if the increase in these commissions is 20\%, for example, the auditor should investigate the reason therefor.\(^3\) Sometimes the difference in accounts is due to a change in policy of handling certain items, whereas in other instances the examination will reveal unusual items of vital concern to the auditor.

Although 99 9/10\% of these investigations will fail to find errors, nevertheless, the auditor must not regard this as discrediting testing methods. They are an INDISPENSABLE part of his sense of proportion and balance.

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1. Including the large amounts for the entire year.
3. There are, of course, many accounts which are quite constant and others which do not vary directly with every increase in Sales.
746. Export Sales.—Ordinarily export sales may be treated as sold even though they are shipped to the foreign customers against open drafts. But on the other hand, there are many, many instances which call for practically no judgment for one to see that the client should wait until the collecting banks in the foreign countries report payment of the open drafts, or at least acceptance thereof. In between these two extremes are numerous cases calling for considerable reflection and deliberation to which no arbitrary rules-of-thumb can be applied. If the client has taken up the sale, but the auditor cannot agree with this procedure, he MUST at least call attention to the situation by a foot note. In some instances, the value of the goods, even as inventories, is nil.

747. Inter-company or Departmental Profits.—See Section 260.

748. The Cash Books.—In a strict balance sheet audit, the auditor is only required to prove that the concern has as much cash as its ledger account shows. Hence, if the auditor prepares a reconciliation of the books with the bank as at the audit date, and again as at a date of his own choosing, he has accomplished all that is required of him. A bank reconciliation must, of course, be independently proved, such as by confirming the bank balance and the deposit in transit by direct correspondence with the bank, by carefully analyzing the make-up of the deposit in transit lest it contain a bogus check, a kited check, etc., by subjecting the outstanding checks to a complete audit when they are returned cancelled by the bank (preferably before the auditor leaves the engagement, otherwise at the beginning of the next audit), and so on.

Although the above is true, nevertheless, few balance sheet audits will be conducted where the verification of cash will be limited to the above procedure. Some or all of the procedures for detecting fraud and/or error, as described in chapters 12 and 13, will be used, but only to the limited extent which the senior-in-charge thinks best.

Naturally, in a detailed audit the verification of the cash will be more elaborate, but just how elaborate will depend upon such factors as the desires of the client, the adequacy of the system of internal check, the facts to be certified to, and other similar factors. At least all of the procedures outlined in chapters 12 and 13 will be used quite extensively.

Furthermore, in a cash audit, the auditor must remember that only a SUPERFICIAL verification of the cash can be made by merely checking the accuracy of the CASH BOOK. It is the other accounting records, including also auxiliary and primary data, to which the auditor needs to direct his main attention. The student should now re-read section 30.

Again, the auditor must remember to tie-in the payments made by check to the vouchers which they pay. Thus if cancelled checks are checked to the Cash Payments Book for March, for example, the columns should be footed, the forward should be checked, the crossfootings at the end of the month should be verified, the postings to the General Ledger and to the Creditor’s Ledger should be checked, AND IN ADDITION the vouchers substantiating these payments SHOULD BE audited.

749. The Sales Book.—As experience shows that there is more fraud and/or manipulation involving accounts receivable, sales and/or cash received on account, than in any other division of the activities of a business, the

1. Impending war, violent fluctuations in exchange rates, impending unfavorable tariff legislation, past record of the client’s with the particular customer or with customers in that region, customers in very remote and unknown regions, etc.

auditor should vouch, in a detailed audit, the entries in the Sales Book and verify the footings, the amounts forwarded, and the postings thereof, including the entries, etc., in the individual customers' accounts, to a greater extent than in the case of the other books of original entry, except the Cash Book and the Journal. However, it should be understood that if the auditor confines his attention chiefly to a verification of the entries in the Sales Book, his auditing will be largely ineffective. As most frauds are based on the entire omission of the sale from the Sales Book, and as many window dressing frauds consist in entering fictitious sales (which give rise to inflated accounts receivable and profits), the auditor must use such primary and auxiliary records and data as the salesman's Order Book and the Shipping record. Furthermore, and equally important, this type of auditing will reveal unintentional overlapping of sales.

As to the necessity of checking the postings to the customer's ledger, assuming a detailed audit, it may be stated this need not be done (1) if these accounts have been footed; (2) if the balances have been proven; (3) if the balances have then been added and found to be in agreement with the controlling account; and (4) if the controlling account has been proved by the checking of the postings, footings, and balance. However, even these four steps are rarely ever carried out completely. Most auditors rely (1) on the random checking of any 15-20% of the postings by a combination of the analysis and the check method; (2) on the footing of about the same number of accounts including, of course, the verification on their balances, (3) on the complete verification, i.e. postings, footings, and balance, of say 10% of the accounts; and (4) on the independent totaling of the account balances for the purpose of checking the total against the balance of the controlling account.

In summary, therefore, it may be said that in a balance sheet audit, the auditor usually confines his attention to the last month of the audit period for the primary purpose of detecting overdrafts and fictitious sales and for the secondary purpose of detecting cash and/or merchandise frauds. Furthermore, little if anything is done with the customers' ledger, assuming a good system of internal check, other than the totaling of the account balances. But in a detailed audit, the testing of the SALES BOOK will cover not only the last month completely, but also the large amounts of the other months of the period, including the footing of about every seventh page and the checking of the forwarded amounts. The last page of every month should always be footed and crossfooted, and the postings to the general ledger should be checked. The amount of auditing in the case of the customers' ledger has been indicated above.

Finally, the importance of ascertaining that the CASH SALES have been properly accounted for must be stressed. As was pointed out hereinbefore, it is advisable to have separate clerks as cashiers, so that the sales force may give its sole attention to servicing the customers promptly. Furthermore, when the salesmen or delivery men make collections, the auditor should test check these activities as they are often a fruitful source of theft. Cash register readings, unused tickets, undelivered C.O.D. packages, and the like, should all be used in testing the cash sales.

750. The Journal-- See Chapter 15, section 186; and Chapter 9, section 112.

1. The perpetual inventory ledger, if any, should be used to test both the sales and the returned sales.
2. See Section 107.

752. Frauds in Inventories.--In a detailed audit, the auditor should give some attention to frauds in inventories, as well as to the more important aspects of determining their proper valuation, the existence of liens, the separation of obsolete and slow moving goods, the erroneous omission or addition of items, their proper classification, the existence of the goods, the correctness of the quantities, and so on.

The most common frauds in inventories consist of actual thefts or of manipulations in the inventory figures. The former will be committed by subordinates, whereas the latter will be engineered by a "high official". In either case the methods of detecting it are in part the same, such as by applying ratio tests, by using receiving and shipping records, etc., by using physical unit tests, and the like. Whenever possible, a reconciliation of the final inventory with (1) the beginning inventory, (2) plus the net purchases or production or both, (3) less the net sales, should be made. The installation of a perpetual inventory record is often advisable, not so much to reduce theft as to reduce the investment in inventories, including also control over them so that there is no delay in production schedules.

In conclusion, it may be stated that where either consignments-in or consignments-out exist, the auditor must exercise extraordinary care to see that all phases of these activities have been properly recorded.

753. Verification of Footings and Postings.--The weight of opinion of leading auditors is decidedly to the effect that the least important part of an audit is the verification of the footings and postings, and that it is indeed a very small concern, or one with a very poor system of internal check, that demands the verification of all footings and postings.

Moreover, one must realize that in preparing the various schedules for the working papers, the auditor automatically checks the footings and postings of these accounts. Thus, in analyzing the LAND account for his working papers, the auditor first ascertains the name of the journal and the page number from which the entry, which he is analyzing, came. Then he refers to that journal, say the Voucher Register, in order to get the voucher number. With this information before him, the auditor is then able to get the particular voucher concerned and analyze it to see if the bookkeeping entry is correctly drawn up. Likewise, before leaving this account, the auditor will quite naturally foot his working paper schedule and obtain the balance, so that he can prove the completeness and accuracy of his figures by comparing it with the balance in the ledger account. In brief, since the auditor, in preparing his various working papers, has really checked the footings and postings of these ledger accounts, there is little if any need for checking the other accounts not included in the working papers. And certainly there is little or no justification whatever for following the common practice of assigning two juniors, say, to the task of checking the postings and footings of the accounts which have been analyzed.

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1. E. G. bricks at a kiln, bales of cotton at a cloth mill; see Section 793.
2. See sections 120, 121, 122.
Again it is emphasized that, even in a detailed audit, the sub-
ledgers are rarely ever checked out completely, or anywhere near completely.
Some of the checking of the postings should be by the check method and some by
the analysis method. Some other few accounts should be completely checked
out, as to postings, footings, and final balance, for the current audit period,
-- rarely ever starting prior to then. Some few accounts, not yet checked in
any manner, should be footed and the balance PROVED -- not taken for granted
upon finding the footings correct. Finally, all of the balances should always
be taken off independently. The client's adding machine lists, etc. should
never be accepted, even on the basis of checking the items against the sub-
ledger accounts. The auditor may easily be lulled asleep, by the monotony of
the checking, into passing things which would attract his attention if he were
wide awake, or the machine list total may be falsified, or what not. Almost,
the client's list should be used by the auditor only as an aid in finding an
error in his OWN list.

In footig books of original entry it is ordinarily sufficient to
foot the controlling debit or the controlling credit columns, and scrutinize
the remaining credit, or the debit, distribution columns, EXCEPT that at the
end of the month the total of the debit columns should be seen to be equal
to the total of the credit columns. Thus in the Cash Receipts Book the debit
columns would be controlled by being footed, and the credit columns would be
scrutinized, in the Cash Payments Book the credit columns would be footed,
and the debit columns would be scrutinized, and so on throughout all of the
books of original entry.

In footing such things as inventories, the auditor ordinarily need
not verify the footing of the unit dollar column. And, in the Voucher
Register, for example, the cents columns do not have to be footed.

At this point the student should re-read Sections 120 and 121.

754. Ticking, Etc.-- See Section 122.

755. The Trial Balance.--ONE of the best procedures for the auditor
to adopt in accounting for all income and expense, including related assets
and liabilities, is to reflect upon each item in the trial balance for what-
ever light it will shed upon usual and unusual sources of income and expense.
Thus in many mill villages in New England, for example, the auditor will find
that the client's trial balance will disclose some such account as INVESTMENT
IN RESIDENTIAL PROPERTY, whereupon there should flash upon the auditor the
necessity for carefully accounting for the rents due therefrom. This train
of thought should lead to other similar possibilities, such as sales of wood,
coal, etc., by the Corporation for the ease and benefit of its employees.
Again, for example, a time certificate of deposit implies the receipt of
interest; an account for salesman's traveling expense suggests the possibility
of padding the expense and of overlapping expense reports; and so on.

756. Petty Cash Vouchers.--In a detailed audit, the petty cash
vouchers should be examined to some extent, say a month at the most, not
because these transactions are important nor because the auditor is likely
to detect well concealed fraud, if any exists, but because of the good moral
and morale effect which it has on the client's petty cashier and upon the
office employees in general. The facts are that the auditor has a somewhat
slim chance of detecting any fraud unless, of course, it is clumsily executed.
The client's real protection lies in appointing a clerk (other than the petty
cashier) to review the petty cash vouchers before they are entered in the
Voucher Register for reimbursement. This approval clerk should be instructed
to ascertain that the services, goods, etc., represented by the vouchers have been received. Naturally, this fact can best be done the day following the origin of the petty cash voucher. If the checking of the validity of all vouchers is deferred until the end of the month, for example, the difficulty of verifying the receipt of the goods and services is often tremendously increased.

757. Rentals.--The rate of the rentals, as shown by the RENT REGISTER, should be checked against the leases signed by the tenants, including also the amount of the guarantee deposit, if any. From this point the cash book receipts from rentals should be checked into the RENT REGISTER, whereupon a list of the rentals which are in arrears should be prepared. This list should then be checked with the respective tenants by direct correspondence. All vacancies should be listed, including the date on which they became vacant, for approval by a responsible officer. Finally, it is important to see that that portion of the cash receipts which represents reimbursement by the tenants of such expenses as water, taxes, etc., is so classified. Frequently all of the receipt is erroneously credited to rent income.

758. Returned Purchases and Allowances.--It is ordinarily considered advisable for the client to write up the returned purchases and allowances in advance of receiving the creditor's Credit Memo thereon. When this policy is adopted, the auditor should see that the Credit Memos are actually received. This can be tested either by checking the creditor's Monthly Statement against the account payable or by checking the Credit Memos against the corresponding adjusting entries. If any credit Memo is long overdue, the auditor should address the creditor on the point, lest the facts be that he is not going to allow the adjustment, etc.

759. Agent's Reports.--As the reports of field agents are primary data, the auditor should always strive to make use of them in testing the correctness of the accounts. Thus fire insurance agents render reports to the Home Office, rental agents render reports to the property owners, consignees render account sales to the consignor, and so on. Accordingly, in a detailed audit especially, the auditor must not fail to use these records in TEST proving that the agents' reports of sales were properly entered by the client, including also the cash receipts and expenditures as per these reports. Finally, the auditor should see that all commissions due or receivable have been taken up, and properly computed.

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1. This is done by taking the petty cash vouchers to those for whom the expense was incurred and securing their written approval on the voucher itself. When the goods or services are not for anyone in particular, it is the duty of the purchasing agent to O.K. for their receipt. All vouchers should then be stamped, "AUDITED".

2. If the deposit consists of coupon bonds, the auditor should ascertain how the matured coupons have been handled.

3. At most this will not be more than a very limited test.
760. Inventory Ledgers.—When a perpetual inventory is kept by the client, as if often the case for example with jewelers selling valuable merchandise, the auditor should test the INS and OUTS on the merchandise stock records against the RETURNED SALES BOOK and the PURCHASE BOOK, and against the SALES BOOK and the RETURNED PURCHASE BOOK respectively.

761. Deferred Income.—On some audits the greatest care possible must be given to the item of Deferred Income. Many clients are likely to consider that advance receipts (or "sales") represent current income.

762. See Plate 234.

1. Or against such books of original entry as contain these transactions.

2. Insurance companies, publishers, correspondence schools, industrial testing laboratories, business schools and colleges, street railways, railroads, etc.
THE R. S. WORCESTER CO., INC.
Audit Program
December 31, 1931. (Detailed Audit)

5 PURCHASES

<table>
<thead>
<tr>
<th>No.</th>
<th>Task Description</th>
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<tbody>
<tr>
<td>2</td>
<td>Test the Receiving Record against the Voucher Register for Dec 15-31, 1931 and for Jan. 1932.</td>
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<tr>
<td>3</td>
<td>Test stock cards for Dec. 1931 against Register</td>
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<tr>
<td>4</td>
<td>Ascertain full details on purchase commitments</td>
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<tr>
<td>5</td>
<td>Obtain Certificate on Liabilities from Mr. Rose</td>
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<tr>
<td>6</td>
<td>Examine cash disbursements for Jan. 1932 for 1931 purchases</td>
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<tr>
<td>7</td>
<td>Ascertain if there are any future price adjustments to be granted by the creditors</td>
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<td>8</td>
<td>See that the open items in the Register check with the controlling account</td>
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<tr>
<td>9</td>
<td>Omissions</td>
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<td>10</td>
<td>Omissions</td>
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<tr>
<td>11</td>
<td>(15) See that Credit Memos have been rec'd for Dec.</td>
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<tr>
<td>12</td>
<td>(16) Investigate debit balances in creditors' accounts</td>
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<tr>
<td>13</td>
<td>(17) Check creditors' Monthly Statements to client's records</td>
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<tr>
<td>14</td>
<td>(18) Ascertain if client is interested in any creditor's business</td>
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<tr>
<td>16</td>
<td>(20) Test Shipping Record against returned purchases for Dec. 1931, and</td>
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<tr>
<td>17</td>
<td>(21) Test stock cards for Dec 1931 against Shipping Record</td>
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<tr>
<td>18</td>
<td>(22) Check the Disbursements Book against the closed accts in the V. Register. April, July and Dec. 1931</td>
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<tr>
<td>19</td>
<td>(23) Foot the V. Register for Apr. and Dec. 1931</td>
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<tr>
<td>20</td>
<td>(24) Post the V. Register to the Gen'l Ledger for Apr &amp; Dec 1931</td>
</tr>
<tr>
<td>21</td>
<td>(25) Check all invoices over $1000 Stamp invoices examined</td>
</tr>
<tr>
<td>22</td>
<td>(26) Pay special attention to distribution and see that ALL approvals have been initialed.</td>
</tr>
</tbody>
</table>

762. Explanation and Comments.--This plate is self explanatory.
The student should regard it as a brief summary of the chapter in respect to PURCHASES.
REVIEW QUESTIONS

1. What is the auditor's chief duty in respect to auditing an inventory of advertising supplies, souvenirs, etc?
2. To what extent should the auditor check up on the honesty of salesmen's hotel bills, etc.?
3. Should the auditor check prices, extensions, and footings on invoices and vouchers?
4. When should freight and similar costs enter into the inventory price?
5. What is the true function of the Profit and Loss account?
6. Upon what basis should an auditor base his decision to overlook overlapping adjustments of say Salesmen's Traveling Expense?
7. Can appreciation be used to offset current depreciation?
8. When should per cent methods be used to estimate the bad debt expense?
9. Should the Organization Expense account be written-off? Why?
10. Should all freight be charged either to a freight-in or freight-out account?
11. What points must the auditor cover in auditing Consignments-in?
12. What are the chief reasons for analyzing the Interest Income and the Interest Expense accounts?
13. How should the excess of a bad debt loss over its specific allowance be handled?
14. When is deferred advertising an OTHER ASSET?
15. In making a detailed audit, why is it necessary to start from a prior authenticated position, i.e. a correct balance sheet?
16. An auditor ascertains that the client has a good system of internal check on payrolls. What point should the auditor cover next?
17. What is the chief reason for auditing the Legal Expense account?
18. What points must the auditor cover in auditing Consignments-out?
19. State some of the problems encountered in dealing with "Income and expense" arising prior to the commencement of operations. Give the solutions to them.
20. If the Organization Expense account is written-off, how should it be done?
21. How should Vouchers be examined?
22. What problems are often involved in Export Sales? Give the solution to them.
23. How should the Cash Payments Book be tied-in with the Voucher Register?
24. What are the Returned Sales adjustments that may be taken up as at the audit date?
25. What are the chief reasons for analyzing the Insurance accounts?
26. How should the Purchase Book be audited on a balance sheet audit? On a detailed audit?
27. What is the value of having duplicate Journal Vouchers?
28. What are some of the problems encountered in evaluating Work-in-Process?
29. Draw up a table of repairs and depreciation expense such as appears in an Auditor's Report.
30. How should bad debt recoveries be treated?
31. Give some rules for testing the accuracy of expense and revenue accounts.
32. What would you do in auditing the Sales Book on a detailed audit? On a balance sheet audit?
33. How should inter-company and/or inter-departmental profit be handled? Illustrate with a problem. State the premises.
34. How may the perpetual inventory ledgers be used in auditing the Accounts Receivable? The Accounts Payable?
35. What are the most common types of inventory frauds?
36. How should the Rentals account be audited?
37. To what extent and how would you audit the Customer's Ledgers on a detailed audit? On a balance sheet audit?
38. In what businesses is Deferred Income a very important element?
39. How should agents' reports be used by the auditor? Illustrate.
40. To what extent should petty cash vouchers be checked in a detailed audit?
763. Introductory Comment. -- As the scope of this topic is so broad and far reaching in all of its ramifications, the following presentation must of necessity be very fragmentary and sketchy. Most of the comments will be related to investigations made in contemplation of the sale of a business, or the floating of bond and/or stock issues. (No attention has been paid to the order of the following comments).

764. Working Papers. -- If there is ever a time when the auditor needs to make copious but clear cut working papers, it is when he is conducting an investigation. Moreover, it is also here that the ingenuity of the auditor is taxed to its utmost in devising new working paper forms that will develop the facts wanted most expeditiously and directly. Again, it is well to emphasize that the adjusting entries should be fully explained, including citations as to where the supporting facts may be found IN THE WORKING PAPERS, NOT in the client's books except secondarily. Reconciliations should always be made and preserved between the book figures and the report figures, even when the final results are the same; i.e. where the original figures are merely revamped. Finally, it is advisable to preserve this type of working papers somewhat longer than the ordinary run of working papers.

765. Scope of Work. -- Naturally, it is the client who will outline to the auditor what it is that is to be investigated and certified to -- not vice versa. On the other hand, it is the auditor, not the client, who should determine the amount of auditing that is necessary to accomplish these objectives.

---

Too much emphasis cannot be laid upon the above two points. The auditor cannot possibly spend too much time in discussing and defining the objectives of the engagement with the client. Time and time again it has happened that the auditor, in his anxiety to get, or to start the engagement, has plunged too soon into the actual auditing without, as it develops later, a very definite idea of just what his client really desires of the audit. Of course, when this is so, the auditor can (and should) always communicate with the client and arrange for a further interview, but he will not usually do so because it will openly disclose his incompetency. As a result, under such circumstances the auditor cannot help but do too much or too little auditing, and his Auditor's Report will correspondingly be too comprehensive or too brief for the parties interested therein. The disastrous results to the auditor's reputation are self obvious.

To repeat, then, much more time should be spent in discussing the scope of the audit with the client, and later, in deciding upon and drawing up a broad audit program to accomplish this objective, than is customary in the case of the general run of audits. Again, if the Auditor's Report is for a specific person, bank, etc., it is advisable for the auditor to ascertain from that party what features of the business are of special interest and significance to him. Of course, such interviews should not stifle the auditor's own ideas and ingenuity in determining, ascertaining, and presenting outstanding facts. Indeed, on investigations this is by far the most important single aspect of the auditor's skill — most any well seasoned senior can handle the actual auditing and the gathering of the facts once they are decided upon.

Finally, as a measure of precaution against criticism and/or misunderstanding, it is recommended that the auditor send a Letter of Engagement to the client, wherein he should give just as clear a description of the objectives, etc. of the investigation agreed upon with the client as it is humanly possible for him to embody in a reasonably brief letter.

As to the amount of auditing which is necessary to ascertain the objectives of the engagement, this decision must rest entirely with the auditor. Therefore, he must remember that it is very dangerous indeed for him to undertake a project wherein the client has very definitely restricted the amount of auditing, for experience shows that insufficient qualifications will be put in the Auditor's Certificate, in an effort to make it acceptable to the client, to call the average person's attention to this point.¹

766. Previous Audits.— On many investigations made in anticipation of new bond and/or capital stock issues, the auditor will find that the client is being regularly audited by another firm of auditors. Usually it is a case where the New York bankers, for example, do not know the reputation of the local auditing firm and prefer to have a national firm make the investigation. Sometimes, however, the client's auditors are

¹. On the other hand many investigations do not require much auditing, but largely the revamping of prior statements into correct presentations.
also a branch of a national firm. The reason for "switching" auditors (by the bankers) may then be because of prior unpleasant dealings of one sort or another with the client's firm of auditors, or in the case of consolidations the firm which audited the leading company of the group is likely to get the audit; and so on.

In most instances the auditor will feel that he can rely upon the reports of previous auditors, but it is doubtful if he can cast off much responsibility by so doing, unless the standing of the other auditors is well known to him, and provided also that the report itself is one of merit and practically unqualified. At this time it may also be well to state that an auditor should not be so self centered as to refuse to consult personally with the client's auditors upon any points about which he is doubtful. Indeed, it is recommended that a visit to the other auditors be made merely for a general chat in respect to the past affairs of the client, for it may be rewarded by a stock of valuable information not otherwise gleaned except by the merest chance or by much auditing.

767. Professional Duty. -- Investigations are so often conducted under pressure, and the importance of the client (banker, or other intermediary or primary party) awaiting the Auditor's Report is often such that the auditor is very apt to lower his professional standards on so-called moot points, to an extent not ordinarily practiced. It behooves an auditor, therefore, not to let the rush of the engagement, or the importance of the parties interested in the outcome of the investigation, or to swerve him from "honorable motives and straightforward dealings." He is expected to render his OWN opinions, for it is upon that basis that his certificate is valued, and sought, for example, for presentation to the bankers and/or to the investing public.

768. Appraisals. -- If the auditor knows that an appraisal is to be made of the plant property, he should hasten to consult the appraisers so that an appraisal of the proper type may be made. The auditor is chiefly interested, of course, in determining what portion of the excess of the appraised sound value over the net book value is earned surplus, and what portion is capital surplus. Most appraisals, of course, do not give this information. Moreover, the accountant does not have use for depreciation allowances based upon present state of efficiency of operation.

769. History of the Client. -- In an investigation made for a prospective purchaser, the auditor should give considerable attention to ascertaining the essential features relative to the origin and subsequent history of the concern. Within professional limits, the future may be pictured. More and more accountants are realizing that they cannot and should not limit themselves to the mere examination of accounts and the subsequent reporting of "sphinx like figures" ascertained thencefrom. As long as the auditor does not prognosticate, he can vitalize these figures and other facts within a wide range of attractive and enlightening presentations, both in words, charts, and graphs.

1. Few auditors will refuse, under such circumstances as these, to talk with the "new" auditors.
2. This should not be given except upon permission of the client.
3. I.E. certain FACTS relating to the future, such as, for example, important changes in the officer personnel soon to go into effect.
770. Customers.-- In addition to assembling the figures on the Gross Sales, Sales Returns, Bad Debts, Reserve for Bad Debts, and the like, the auditor may also deem it profitable to make some investigation into the following aspects of the client's customers:

(a) Name and amount of sales to the chief customers.
(b) The number of present customers.
(c) The increase in number of customers from year to year.
(d) Location of the customers. Concentrated? If so, where? Foreign trade? Where? How much?
(e) Similar inquiries as the above, pertinent to the particular business being investigated.

771. Net Sales.-- In many investigations it is important for the auditor to carefully verify the composition and accuracy of the Net Sales. Many a prospective purchaser, for example, is more interested in the net sales than in the final net profit, because he feels that if the income is reasonably steady and assured, the present outlay for operating expenses is largely immaterial, seeing that under his management they can be cut to the proportions attained by him in his other plants. That this is quite likely to be true is obvious; on the other hand, it is equally obvious that this program will not hold for some businesses.

The reader should now turn to Appendix C, Section 15-4.

772. Sales of Raw Materials.-- It sometimes happens that in a rising market, a business will find it profitable to sell some of its stock of raw materials. Such sales must always be stated separately. If they are included in the regular sales, a gross error is being made. The proper credits are to PURCHASES and PROFIT ON SALE OF RAW MATERIAL.

The same sort of correction must be made if there has been a fire, the insurance proceeds from which, in respect to the goods, have been credited to sales.

773. Leases.-- If a concern leases its land and buildings, the auditor should report upon this topic very fully. Obviously, the interested parties will be pleased to know: (1) how much the annual rent is; (2) how long the lease runs; (3) if the lease provides for an increase or decrease in the rent; (4) if the lease can be renewed and under what conditions; and so on. Thus one prospective purchaser may want to know how long he can remain in the present site, whereas another purchaser may want to remove the business to other quarters. In either case the terms of the lease MAY be the determining factor which caused the purchase or the rejection.

774. Auxiliary Information.-- The ascertainment and presentation of such auxiliary information as (1) unfilled sales orders, (2) unfilled purchase commitments, (3) present and/or future bonus and profit sharing agreements, etc., are wholly within the auditor's field of investigation. He should never take the point of view that these are matters entirely extraneous to auditing. In fact, it has been this NEGATIVE attitude which has caused some "auditors" to be bookkeepers out of a job.

In respect to the sales and purchase contracts, the auditor should ascertain (1) if they can be cancelled; (2) if the inventories on hand plus the purchase commitments will cover the sales commitments; (3) if the sales commitments are profitable; (4) if the purchase commitments are above or below the present market price and its probable future trend; and (5) all similar facts necessary to determine if these contracts are
favorable or unfavorable. As much definiteness as possible should be
given to these comments, such as, by giving the sums involved, even though
they be but rough approximations.¹ Such an assignment is often a very
difficult one to fulfill, but such is the lot of the SUCCESSFUL auditor.

775. Peaks.-- Just as comparative Profit and Loss Statements and
Balance Sheets are difficult to have but they be, through pictures
adequacy is obvious, given parties an option for one to five to ten
favorable to take in the lean as known facts.

Unusual expenses is dangerous because it presupposes that

has occurred extraordinary credits and debits.

Operating income and expense must always be kept free of miscellaneous
and extraordinary credits and debits.

All prior statements should be revamped in the light of present
known facts.

776. Data on Cost System.-- Somewhere in the Report the auditor
should comment upon the adequacy of the bookkeeping system and upon the
adequacy of the cost system, if any. This information gives the interested
party an additional slant on the progressiveness of the management, and the
probable accuracy of the figures.

777. Earnings.--It is quite elementary, but necessary, to point
out that the earnings should be ascertained for a number of years, say
five to ten years. The period covered should always be long enough to
take in the lean as well as the good years, because it is very important
for one to know the minimum and the maximum between which the business
has fluctuated. Furthermore, the trend of the business is thus portrayed.
Obviously, a gradual and steady increase in net sales and net profits is
preferable to a reverse trend, or one which fluctuates widely from year
to year.

At this time it is emphasized that the auditor must be extremely
careful in what form he certifies to the earnings. The decided weight
of opinion is that he should not certify to an average profit for a
stated number of years. If he does, he must also show the earnings of
each year separately.²

Operating income and expense must always be kept free of miscellaneous
and extraordinary credits and debits.

All prior statements should be revamped in the light of present
known facts.

778. Elimination of Unusual Expenses.--The elimination of certain
unusual expenses is dangerous because it presupposes that unusual expenses
do not occur under good management. Nothing, however, is farther from
the actual facts. True, under good management the same losses and unusual
expenses do not recur, but other unusual expenses will arise quite
regularly. Hence, if such expenses are eliminated from the net profits,
the auditor should somehow state their nature and amount.

¹See Section 267.
²"This (Rex vs Kylsant case) concerned the issuance of a prospectus which,
although true, was misleading, chiefly because it stated that the company
had earned an average substantial profit over a period of ten years when
as a matter of fact the earnings had accrued entirely in abnormal years at
the close of the war. The company had operated actually at a loss during the
latter portion of the decade covered by the statement."—The Journal of Acc-$
102

outancy, Jan. 1932. (p.2)
779. Contingencies.—In the writer's opinion, many auditors restrict
their usefulness by refusing to let happenings which occur AFTER the audit
date influence their presentation of facts AS OF the audit date. They
believe, for example, that it is the business of the interested party to inform
itself as to what changes have taken place since the audit date in the market
value of raw materials, in the demand for the company's finished goods; and
so on. This may be true of men of finance, but it certainly is not true of
the general investing public. Therefore, the auditor must draw up his
statements and address his report to the average level of the least equipped
of those for whom it is intended. Of course, the writer realizes that there
is a point beyond which the auditor's statements and report cannot go in
eliciting the position of the client. But that point is far beyond the
boundary now established by many, even leading, auditors.

780. Inventories.—As the periodic profits are largely dependent
upon the method of taking, pricing, etc., the inventories, the auditor
must analyze them somewhat minutely, particularly in reference to uniformity
of methods throughout the several years being investigated.

Furthermore, as it is perfectly reasonable for the seller to
expect to receive the present market value of his raw materials, including
the extent to which they are also in the goods-in-process and the finished
goods, the auditor should ascertain if this basis of valuation is to be
employed. If so, he must take considerable pains in checking the pricing
of the goods-in-process and the finished goods.

781. Partners' Salaries.—When a partnership is being investigated,
the question of the proper treatment of Partners' Salaries arises. Frequently
these salaries are treated as withdrawals in accordance with strict theory.
In other instances they are treated as operating expenses. What position
on them should the auditor take in matters of this kind? Certainly it is
entirely misleading to the general public for an auditor to state, for
example, that the net earnings of the partnership are so many times the
preferred stock requirements of the proposed corporation, on the assumption
that every one should know that partners' salaries are WITHDRAWALS. On the
other hand, the partners may be expensing the salaries in excess of what is
reasonable under the circumstances, so that here again the figure for net
earnings is not as accurate as one could desire. It seems, therefore, that
either some reasonable figure for partners' salaries should be included as
an expense, or the net earning should be clearly qualified IN THE STATEMENT
ITSELF, as well as in the Auditor's Certificate, thus:

\[
\text{Net Profit (before deduction of partners' salaries of \( \xi \)xx)} \quad \text{xx}
\]

782. Deferred Charges.—All deferred charges must be clearly pre-
sented and adequately commented upon in the Auditor's Report, for it must
be realized that leading authorities often take widely different positions
on what may be properly classified under this heading, including also the
period of time during which the items should be written-off.

1. See Appendix C, Sec. 15-41.
2. Including also any rise in the cost of labor and/or overhead.
3. I.E. the section often designated, OTHER ASSETS.
763. Ratios.—It is in the case of investigations of earnings and financial condition for a prospective purchaser that the auditor can most often employ financial and operating ratios to the best advantage, for the absolute figures are quite often meaningless in themselves. Among the more important ratios are the following:

(a) Ratio of Current Assets to Current Liabilities  
(b) Net Sales per Dollar of Plant Property  
(c) Turnover of Inventories of Finished Goods, Goods-in-Process, Raw Material, etc.  
(d) Ratio of Net Profits to Total Tangible Assets  
(e) Ratio Liabilities to Networth  
(f) Ratio of Plant Assets to Bonds Payable  
(g) Ratio of Net Profits to Total Networth  
(h) Dollar Earnings per Share on Common Stock  
(i) Ratio of Returned Sales to Gross Sales  
(j) Ratio of Cost of Goods Sold to Net Sales  
(k) Ratio of Each Major Classification of Operating Expense to Net Sales  
(l) Ratio of Financial Income and Financial Expense to Net Sales  
(m) Ratio of Net Profit on Operations to Net Sales  
(n) Ratio of Each Asset to the Total Assets  
(o) Ratio of Each Asset to the Total of its Own Group  
(p) Ratio of Trade Receivables to Net Sales  
(q) Ratio of Each Expense to the total of its Own Group  
(r) Ratio of Surplus to Capital Stock  
(s) Ratio of Net Profit to Net Sales  
(t) Ratio of Dividends to Net Profit  
(u) Net Sales per Dollar of Networth  
(v) Net Sales Per Dollar of Total Assets  
(w) Ratio of Gross Profit to Net Sales  
(x) Ratio of Each Liability to the Total Liabilities  
(y) Ratio of Each Liability to the Total of its Own Group

764. Charts and Graphs.—As stated hereinbefore, few auditing firms use charts and graphs in their "every-day-run" of Audit Reports, despite the well known fact that these methods of presentation are often the clearest and simplest to understand. As to these few pioneering firms, most of their endeavors are confined to reports on investigations, for then there is most apt to be allied with the entrepreneurs one or more engineers to whom such presentations are mere matter-of-fact procedures.

765. Comparative Statements.—Condensed comparative profit and loss statements and balance sheets, for say at least 5 years, are most helpful to one in sizing up the past success of a business, its present condition, and, in part, its future outlook. Not only should the absolute figures be given but also the per cents thereof, including the increase or decrease in the absolute figures and their per cents.

766. Current Statements.—Ordinarily, the auditor should be wary of preparing statements that are dated more than 4 to 60 months prior to the actual date of auditing. And in all cases he should review and scrutinize the current intervening period for the purpose of ascertaining if any important changes have occurred. If so, these must be embodied in the statements or disclosed in the Auditor's Certificate. Conditions change so speedily that omission to cover this point is equivalent to committing
professional suicide. It will avail the auditor but little to call attention to the date of the statements, and the date of the issuance of the Report.

767. Quantity Units.—If it is possible for the auditor to tie-in the profit and loss figures with physical units of sale, production, etc., the usefulness of these statements will be TERRIBLY increased. This is a point of procedure that cannot be over emphasized although it is not commonly employed.

768. Analysis of Gross Profit.—One of the most valuable analyses is that which ascertains the division of the change in the amount of gross profit as between (a) that due to the change in the sales volume (which in turn should be subdivided into (1) changes in physical quantities sold, and (2) changes in unit sales prices) and (b) that due to the change in the unit cost of the goods sold.

A customary procedure is to ASSUME that the unit cost of the goods sold has remained constant, whereas the actual facts may not bear out this assumption. Hence, this analysis can be used only in a very limited number of instances where very definite facts are ascertainable.

769. Extraordinary Earnings in Regular Lines.—If the client has made and is making extraordinary earnings through regular sales which will not continue long into the future, the question arises as to whether or not the auditor must comment on this point, or whether the ascertainment of this fact is up to the purchaser. Some auditors maintain that they are not called upon to segregate or comment upon such transactions as these, whereas other auditors feel that the least they can do is to call attention to the situation. The writer believes that in most cases the auditor is called upon to make some sort of comment. If he does not, his report is apt to be merely a half-truth; i.e. good as far as it goes, but NO GOOD as a reliable source upon which to enter into contracts of considerable moment.

790. Statement of Application of Funds.—One of the most enlightening presentations in respect to the use to which the profits have been put is embodied in the type of exhibit commonly known as the Statement of Application of Funds.

Although the exact contents of such a statement is still a matter of discussion among eminent accountants, nevertheless, some such presentation is, to repeat, highly desirable. The following one is illustrative both of its value and of one form thereof.

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1. See Chapter 52, Section (b) — EARNINGS
2. See Chapter 53, Section 592
UNITED STATES STEEL CORPORATION AND SUBSIDIARY COMPANIES

SUMMARY OF THE FINANCIAL OPERATIONS OF ALL PROPERTIES

Showing the Net Resources and Disposition Thereof for Year Ending December 31, 1930

NET RESOURCES

Surplus Net Income for the year, page 17 ....................... $ 18,836,007.40
Net Receipts appropriated from Earnings for Depletion, Depreciation and Obsolescence Reserves ............... $458,550,120.14
Receipts during the year for account Blast Furnace Relining and Current Maintenance
Reserves ................................................. 5,026,193.64
Sundry Credits to foregoing accounts ......................... 193,188.77
$63,769,502.75

Less—Payments to Trustees of Bond Sinking Funds ............. $377,560.02
Expended for Extraordinary Replacements for Blast Furnace Relining and from Maintenance Reserves .... 4,654,504.43 5,232,064.50
Balance of Receipts for the year for account of the above reserves .............................................. 58,537,438.25
Payments and receipts during the year account of Insurance, Contingent and sundry operating reserves .......... (Dr.) 470,670.70
Federal Income Tax refunds (net) account previous years' tax payments .............................................. 18,322,393.70
Common Stock issued and/or sold at total valuation of .......... $94,600,207.92
Of which total there was represented by valuation of properties, plants, and business, including net current and working assets of Atlas Portland Cement Company, Columbia Steel Corporation and Oil Well Supply Company, acquired with issues of above stock ........................................... 91,570,334.92
Balance being value received for stock issued under Employees' Stock Subscription Plan ......................... $3,029,873.00
Net Installments paid in by employees under Stock Subscription Plan, in excess of liquidation of Subscriptions by issue of stock on full payment and by withdrawals of subscriptions by cancellation .............................................. 443,437.64
Total Net Resources for the year ................................ $98,698,569.29

PAYMENTS MADE FOR THE FOLLOWING PURPOSES:
Expended for Additional Property and Construction, and net outlays for Stripping and Development Work at Mines . . . . . $144,439,695.23
Bonds, Mortgages and Purchase Money Obligations redeemed and paid off (net) including premium of $66,650 paid in redemption of U.S. Steel Corporation bonds, non-called series ... $10,725,452.98
Payment of the foregoing was made in part with moneys in hands of Trustees of Bond Sinking and Redemption Funds on deposit for that purpose, to the amount of ... $8,691,507.72 ... $2,033,945.26
Payment to Sinking Fund Trustees in addition to amount of such payments made from reserves appropriated from Earnings as above ... ... $391,902.50
Net additional payments for Advances Mining Royalties and Royalty Notes ... ... $1,651,942.31
Net increase in investments in Outside Real Estate, Land Sales Contracts, Employees House Sales Contracts, Sundry Stocks, etc ... ... $334,891.70
Sundry Miscellaneous Payments ... ... ... ... ... ... ... ... $161,693.99
Excess of Payments made over amount of Net Resources for The Year ... ... ... ... ... ... ... ... ... ... $149,013,675.99
The foregoing excess of payments was provided from net working assets as shown below:
DECREASE IN CURRENT ASSETS:
In Accounts and Bills Receivable ... ... ... ... $60,378,655.05
"Investments in Securities held in General and Reserve Funds and in Current assets ... 43,421,912.76
"Cash, General and Special Accounts ... 6,766,066.67
Less Increase in Inventories ... ... ... ... ... ... ... ... ... ... 14,061,078.10
Less Increase in Cash in Reserve Funds ... ... ... ... ... ... ... 3,605,337.40

DEDUCT, DECREASE IN CURRENT LIABILITIES:
In Accounts, Vouchers, Pay Rolls Payable, Accrued Taxes and Accrued Interest ... ... 416,423,101.20
Less, Increase in Unpaid Dividends ... ... ... ... ... ... ... ... 222,651.50
Balance, being the decrease in Net Working Assets during the year ... ... ... ... ... ... ... 16,190,249.70

|$ 50,315,307.70
THE BUCKEYE NOVELTY COMPANY
STATEMENT OF APPLICATION OF FUNDS
YEAR ENDED DECEMBER 31, 1926

FUNDs PROVIDED:
By Creditors
By Issue of Bonds - Par Value $50,000.00
Less Discount 3,000.00 $47,000.00
By Owner
By Issue of Preferred Stock (250 shares) 25,000.00
By Business
Net Profit To Surplus $63,250.00
Add: Depreciation $15,000.00
Bond Discount 1,000.00 18,000.00 $69,250.00
Salvage on Machinery Discarded 4,000.00 73,250.00

DISPOSITION OF FUNDS:
To Creditors
Reduction in Current Liabilities (Schedule 2) $10,000.00
To Owner
Dividend Paid on Preferred Stock (7%) 26,250.00
To Invest in Business
Purchase of Furniture and Fixtures $2,000.00
Purchase of Machinery 37,000.00
Improvements to Building 25,000.00 64,000.00 100,250.00
INCREASE IN WORKING FUND (Schedule 1) $45,000.00

ANALYSIS OF CHANGES IN WORKING FUND

WORKING ASSETS

<table>
<thead>
<tr>
<th></th>
<th>1925</th>
<th>1926</th>
<th>Increase</th>
<th>Decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$30,000.00</td>
<td>$50,000.00</td>
<td>$20,000.00</td>
<td>$8,000.00</td>
</tr>
<tr>
<td>Accounts Receivable (net)</td>
<td>254,000.00</td>
<td>246,000.00</td>
<td>$8,000.00</td>
<td>$8,000.00</td>
</tr>
<tr>
<td>Inventory</td>
<td>389,000.00</td>
<td>420,000.00</td>
<td>$31,000.00</td>
<td>$2,000.00</td>
</tr>
<tr>
<td>Expenses &amp; Supplies</td>
<td>10,000.00</td>
<td>12,000.00</td>
<td>$2,000.00</td>
<td>$2,000.00</td>
</tr>
</tbody>
</table>

$553,000.00  $728,000.00

INCREASE in Working Assets
$45,000.00

$728,000.00  $728,000.00

$53,000.00  $53,000.00

CURRENT LIABILITIES

AS AT DECEMBER 31, 1925 and 1926, RESPECTIVELY

<table>
<thead>
<tr>
<th></th>
<th>1925</th>
<th>1926</th>
<th>Increase</th>
<th>Decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes Payable-Bank</td>
<td>$60,000.00</td>
<td>$80,000.00</td>
<td>$20,000.00</td>
<td>$25,000.00</td>
</tr>
<tr>
<td>Accounts Payable-Trade</td>
<td>150,000.00</td>
<td>125,000.00</td>
<td></td>
<td>5,000.00</td>
</tr>
<tr>
<td>Accrued Expenses</td>
<td>30,000.00</td>
<td>25,000.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

$240,000.00  $230,000.00

DECREASE IN CURRENT LIABILITIES

$240,000.00  $240,000.00

$30,000.00  $30,000.00

$30,000.00  $30,000.00

1. By Mr. Folon. See Appendix C, Section 27-#1.
FLAXTOWN CORPORATION

STATEMENT OF SOURCES AND APPLICATION OF WORKING CAPITAL
YEAR ENDED DECEMBER 31, 1930

SOURCES OF WORKING CAPITAL
Profit per profit and loss account .................................. 21,087.98
Add charges to profit and loss that did not result in working capital:
Depreciation on cost of buildings .................................. 4,944.56
Depreciation on Machinery and equipment .......................... 19,183.26
Depreciation on furniture and fixtures ............................... 1,083.68
Decrease in deferred charges .................................. 4,465.74
Working Capital derived from operations ................ 50,705.22
Proceeds of machinery and equipment sold .................. 4,250.00
Proceeds of capital stock sold ................................ 55,000.00
Total working capital received .................................. 109,955.22

PURPOSES TO WHICH WORKING CAPITAL WAS APPLIED
Transfer of long-term obligations to status of current liabilities:
Serial bonds .................................. $100,000.00
Equipment notes .................................. 4,000.00

Acquisition of treasury stock .................................. 9,000.00
Satisfaction of judgment .................................. 10,755.20
Replacements and renewals of machinery and equipment ........... 2,143.76
Investment in affiliated companies ............................... 19,918.14
Investment in land .................................. 20,000.00
Investment in machinery and equipment .......................... 19,422.04
Investment in furniture and fixtures ............................. 1,599.90
Declaration of dividends .................................. 35,000.00
Total working capital applied .................................. 225,184.04
Decrease in working capital (Schedule I) .................. 115,228.82

STATEMENT OF DECREASE IN WORKING CAPITAL

<table>
<thead>
<tr>
<th>CURRENT ASSETS:</th>
<th>1929</th>
<th>1930</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>148,375.76</td>
<td>65,672.35</td>
<td>$82,703.41</td>
</tr>
<tr>
<td>Notes Receivable</td>
<td>25,957.45</td>
<td>30,241.37</td>
<td>6,283.92</td>
</tr>
<tr>
<td>Interest</td>
<td>624.62</td>
<td>779.35</td>
<td>154.73</td>
</tr>
<tr>
<td>Accounts</td>
<td>95,612.00</td>
<td>97,728.80</td>
<td>2,116.80</td>
</tr>
<tr>
<td>Inventory</td>
<td>142,376.62</td>
<td>137,956.25</td>
<td>4,420.37</td>
</tr>
<tr>
<td>Securities</td>
<td>32,768.91</td>
<td>25,276.91</td>
<td>7,491.92</td>
</tr>
<tr>
<td>Total</td>
<td>443,404.98</td>
<td>297,795.03</td>
<td>$145,609.95</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CURRENT LIABILITIES:</th>
<th>1929</th>
<th>1930</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Payable</td>
<td>$27,361.37</td>
<td>$43,785.22</td>
<td>$16,423.85</td>
</tr>
<tr>
<td>Notes Payable - Banks</td>
<td>4,000.00</td>
<td>3,000.00</td>
<td>1,000.00</td>
</tr>
<tr>
<td>Equipment Notes</td>
<td>12,000.00</td>
<td>4,000.00</td>
<td>8,000.00</td>
</tr>
<tr>
<td>Cash Dividends</td>
<td>9,000.00</td>
<td>10,000.00</td>
<td>1,000.00</td>
</tr>
<tr>
<td>Contract Prepayments</td>
<td>538.96</td>
<td>50,265.76</td>
<td>29,726.80</td>
</tr>
<tr>
<td>Serial Bonds, due</td>
<td>100,000.00</td>
<td>100,000.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Accrued Interest</td>
<td>17,685.28</td>
<td>8,325.00</td>
<td>9,360.28</td>
</tr>
<tr>
<td>Accrued Wages</td>
<td>2,563.74</td>
<td>8,692.24</td>
<td>6,128.50</td>
</tr>
<tr>
<td>Total</td>
<td>$173,447.35</td>
<td>$293,068.22</td>
<td>$119,620.87</td>
</tr>
</tbody>
</table>

Working Capital .................................. $115,228.82

#Red

THE R. S. COMPANY
STATEMENT OF APPLICATION OF FUNDS
FOR THE YEAR ENDING DECEMBER 31, 1923

Funds Provided:
By Sale of Stock of X Company ........... $15,600.00
By Issue of Bonds at 90 .................. 9,000.00
By Issue of Common Stock at 106 ........ 10,600.00
By Sale of Machinery .................... 1,000.00
By Decrease in Working Capital and Deferred
  Charges (per Schedule 1) ............... 2,075.00
\[Total Provided: $38,475.00\]

Funds Applied:
To Expenditures on Fixed Assets:
  Purchase of Land ...................... $7,000.00
  Purchase of Machinery ................. 5,000.00
  Purchase of Delivery Equipment ........ 3,500.00
  Extraordinary Repairs to Building ... 3,700.00 $19,200.00
To Contribution to Sinking Fund ......... 3,000.00
To Payment of Cash Dividends:
  On Common Stock ..................... 4,800.00
  On Preferred Stock ................... 2,000.00 7,800.00
To Loss on Operations:
  Net Loss per Profit and Loss Statement . 14,450.00
Deduct Expenses not Requiring Funds:
  Depreciation - Buildings .............. $2,000.00
  Depreciation - Machinery ............. 1,875.00
  Depreciation - Delivery Equipment .... 2,000.00
  Bond Discount Amortized ............. 100.00 5,875.00 $8,475.00
\[Total Applied: $38,475.00\]
### The R. S. Company

#### Schedule of Working Capital and Deferred Charges

<table>
<thead>
<tr>
<th></th>
<th>Dec. 31 1922</th>
<th>Dec. 31 1923</th>
<th>Working Capital Decrease</th>
<th>Working Capital Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raw Material</td>
<td>$7,000.00</td>
<td>$6,300.00</td>
<td>$700.00</td>
<td></td>
</tr>
<tr>
<td>Goods in Process</td>
<td>$8,200.00</td>
<td>$8,500.00</td>
<td>$300.00</td>
<td></td>
</tr>
<tr>
<td>Finished Goods</td>
<td>$13,500.00</td>
<td>$13,500.00</td>
<td>$500.00</td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable less Reserve</td>
<td>$12,650.00</td>
<td>$11,200.00</td>
<td>$1,350.00</td>
<td>$3,000.00</td>
</tr>
<tr>
<td>Notes Receivable</td>
<td>$5,000.00</td>
<td>$8,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued Interest on Notes Receivable</td>
<td>$100.00</td>
<td>$160.00</td>
<td>$60.00</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$2,000.00</td>
<td>$1,500.00</td>
<td>$500.00</td>
<td></td>
</tr>
<tr>
<td>Total Current Assets</td>
<td>$48,650.00</td>
<td>$46,750.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current Liabilities:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>$3,200.00</td>
<td>$4,300.00</td>
<td>$1,300.00</td>
<td></td>
</tr>
<tr>
<td>Notes Payable</td>
<td>$5,000.00</td>
<td>$6,000.00</td>
<td>$1,000.00</td>
<td></td>
</tr>
<tr>
<td>Accrued Wages</td>
<td>$170.00</td>
<td>$210.00</td>
<td></td>
<td>$40.00</td>
</tr>
<tr>
<td>Total Current Liabilities</td>
<td>$8,370.00</td>
<td>$10,710.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Working Capital</strong></td>
<td>$40,080.00</td>
<td>$36,050.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Decrease in Working Capital</strong></td>
<td>$2,030.00</td>
<td>$3,350.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Dec. 31 1922</th>
<th>Dec. 31 1923</th>
<th>Decrease</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred Charges:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unexpired Insurance</td>
<td>$420.00</td>
<td>$470.00</td>
<td>$50.00</td>
<td></td>
</tr>
<tr>
<td>Manufacturing Supplies</td>
<td>$675.00</td>
<td>$560.00</td>
<td>$95.00</td>
<td></td>
</tr>
<tr>
<td>Total (as in Statement of Application of Funds)</td>
<td>$95.00</td>
<td>$95.00</td>
<td>$45.00</td>
<td>$2,075.00</td>
</tr>
</tbody>
</table>

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1 Finney, Vol. 1, p.13. See also Appendix C, Section 27-3.
791. Estimates. — Sometimes an auditor is asked to draw up statements on a purely hypothetical basis, so that the bankers, for instance, can visualize more clearly the probable outcome of net earnings as a result of say a certain per cent of increase in sales with assumed lesser per cents of increase in the expenses. Such work as this is proper, PROVIDED the auditor presents his work on paper and in a cover which does not give the slightest clue as to who prepared it. It is improper to use water-marked paper, or paper bearing the printed or written name of the auditor. This applies to the cover also. And as for certificates of any sort whatever, these are strictly tabooed.

792. Profits Before Interest, Executive Salaries, Depreciation, Depletion, and/or Federal Income Taxes. — Whenever the profit is stated before any or all of the above items, and the like, are deducted, the auditor MUST state so unequivocally. This is especially true in the case of depletion and federal income taxes, because the former does not have to be computed in a single project enterprise of the wasting asset type in arriving at its profits legally available for dividends, and because the latter is often looked upon as a surplus charge representing a distribution of profits to the government.

793. Investigations. 1— "An investigation ought not to involve a complete audit, and it is as important to omit as to what to include. Hard and fast rules cannot be laid down, but the general tests and safeguards which should be applied are described here, together with some useful advice on the preparation of the report.

"Investigations which an accountant may be called upon to undertake are of various kinds. There are those in which defalcations have to be detected, those in which the position of a business in difficulties has to be ascertained, and those in which a report is required as to the methods of conducting a business, with specific recommendations for the introduction of improvements. But perhaps the most usual class of investigation is that which is directed to the ascertainment of the value of a business, with a view to its sale or amalgamation or to the provision of further financial resources. It is with this last mentioned class that I propose to deal.

"The starting point of an investigation is commonly to be found in representations which have been made by the proprietors as to the nature and value of the assets and the profit-earning capacity of a business. The merit of such initial representations varies enormously, since they range from a carefully prepared statement, based on audited accounts and professional valuations, to casual jottings prepared without skill and with an imperfect knowledge of the facts. From the way in which the matter is presented, it is often possible to form, almost at the outset, a general idea of the way in which the investigation will have to be conducted. The better the mode of presentation, the easier will be the verification, but it is not unusual to find that the statements which have been submitted are entirely unreliable, and that what is required is not verification but a restatement of facts in intelligible form.

"An investigation ought not to involve a complete audit. It is not so much a matter of vouching transactions over a considerable period, as of ascertaining general results, and the financial position brought down to a recent date. In entering upon the work of investigation it is advisable to take a general survey of the position, to make inquiries as to the conduct of the business, and particularly of the accounting side of it, and

thereafter to draw up a plan of campaign having for its object a general test of the records. It may be the case that the general test will indicate the necessity of a close examination under certain heads, and possibly something which nearly approaches a detailed audit of the books.

"In regard to profits, the results of successive years should be closely compared, and important variations should be the subject of inquiry. In this respect, it will be fortunate if the investigator has had experience in a business similar to the one which he is examining. He will have a means, which he would not otherwise possess, of submitting variations in gross profits and expenses to comparative tests, and of estimating the value of explanations given to him. In cases where this advantage is not present it may be necessary to make inquiries concerning the conditions of the trade under consideration, which will help him to form an opinion whether he is receiving true explanations, or is merely being put off.

"As the work proceeds, the investigator will gradually acquire a feeling either of confidence or of distrust, which is likely to have a material bearing on the tenor of his report.

"In testing the accuracy of a Profit Statement the examination of the stocks plays an important part. By means of manipulation of stock values the general tendency and aggregate amount of the profits can be materially modified. It is by no means sufficient to accept a certificate of stocks without examination of the manner in which values have been computed. A detailed arithmetical test ought not to be necessary, but the basis of stocktaking prices must be the subject of a test, the extent of which can only be gauged as the work proceeds. In many cases, it is not practicable to test the physical existence of the quantities stated in the stock sheets, but a rise in stocktaking values occurring in conjunction with an increase in the rate of gross profit requires close attention. The accuracy of the rate of gross profit can be tested by comparison of selling prices with cost. If not corroborated by the test, it may be found to have been brought by an inflation of stock values.

"It is sometimes possible to test the physical existence of the stock where the product is more or less uniform. A case came to my notice some years ago in which the accounts of a brickworks were being examined for promotion purposes, and no explanation could be derived from the books of account, nor was offered by the proprietors, of a serious loss in one year, although a considerable time had been spent on an endeavor to account for it. The explanation was, however, quickly brought to light when the stock was tested, by adding the number of bricks made during the year to the stock at the beginning, and comparing it with the total of the bricks sold during the year and the stock at the end. The result showed a very large deficiency of bricks, and this, taken in conjunction with the fact that the chairman of the company was a builder, caused the contemplated promotion to be abandoned.

"Where the business is that of a manufacturer, attention must be given to the computation of the value of finished stocks and work in progress. While there is a general tendency to underestimate the cost of manufacture, a contrary tendency may be found when there is a desire to show good results. There should, therefore, be some examination of the costing system, which would guard such an error of principle as would conceal losses, or anticipate profits, by stating manufactured goods or work in progress above the actual cost of production. Such an error or principle is most likely to result from the adoption of too high a rate of oncost (or percentage addition in respect to indirect expense), and it will be necessary to compare the rates of oncost adopted in successive
years, particularly in the last one, with each other, and with the total indirect expenses which they are designed to represent.

"Profits may be appreciably affected by a variation of the method of stocktaking as between one year and another, and in this respect stocktaking must be regarded as including the valuation of work in progress. Inquiry under this head may bring to light a lack of uniformity necessitating adjustment of the figures submitted. You may find, for example, that stock and work in progress have been understated, as the result of a conservative method of valuation during the earlier years of the period under review, and that a departure has been made from this basis in later years as an expedient to increase profits or conceal losses. A concrete example is the deduction from stocks of an overhead percentage on the total, varied in later years by the reduction of the percentage, or by the omission of the practice altogether. As regards work in progress, a similar position would arise from valuing it during the earlier years, at the bare cost of labour and materials without addition for oncost in respect of overhead charges, and adding oncost in later years. A systematic augmentation of the oncost percentage, not justified by changed conditions, would have the effect of inflating profits progressively.

"The safeguards which are usually adopted in the course of an audit, for the purpose of ascertaining whether all liabilities have been brought into account, ought not to be relaxed, but, on the contrary, applied still more stringently during the investigation. Production of creditors' statements at the date which marks the end of the period should be called for, and in instances where the request is not complied with, insistence may be advisable. As a check upon the entries in the Bought Ledger you may call for production of the Storekeeper's Inwards Books, to ascertain whether important deliveries of goods have found their way to the credit of the supplier. This test may be supplemented by making a selection of items from the stock book, and requiring production of the corresponding entries in the Bought Ledger. A further test is the examination of entries subsequent to the end of the period, since they may be found to include items which ought to have been entered during the period.

"Conversely, there is a possibility that, by accident or design, the stock or work in progress may include items for which credit has been taken as sales.

"Contingent liabilities are more difficult to deal with. An examination of a Board Minute Book of a company will often bring to light obligations having a material bearing on the financial position of the undertaking and inquiry may reveal others.

"As regards both actual and contingent liabilities, it is wise to take a certificate from responsible persons that such liabilities have been brought into account.

"Certificates of stock and as to provision having been made for liabilities, should not be regarded as absolving an investigator from the duty of inquiry. When full inquiry has been made, certificates should be obtained from responsible officers by way of authentication and for the purpose of fixing responsibility. Do not yield to an inclination to avoid the difficulties attendant upon inquiry by seeking to cast responsibility upon others. This tendency should be guarded against, since it may lead to blind reliance upon statements which ought not to have been accepted without inquiry. It is too frequently the case that officials will sign certificates without a proper sense of responsibility, or a due appreciation of the import of the certificate.
"A word in regard to taxation may be helpful. In certifying profits and gauging the earning power of a business, income-tax is not regarded as a deduction for several reasons. In the first place, the charge borne by any year in respect of income-tax bears no relation to the profits of that year, because in the majority of cases it is based upon an average of the three preceding years. Income-tax is, moreover, levied at varying rates. Where a company pays debenture interest or dividends on its shares part of the tax, varying with the amount of dividend, is recovered, so reducing the charge to be borne by the company, which tends still further to render the actual debit for the year unreliable as a measure of the tax burden. Deduction of income tax from debenture interest and dividends paid, burnishes another reason for adding back income tax in stating profits since in the case of an issue of debentures or shares, the interest or dividends payable out of profits would be reckoned before deduction of tax, and should be brought into relation with profits computed on a similar basis.

"Excess profits duty and corporation profits tax are now happily things of the past, but they will, for some time to come, be encountered in investigations which extend back over a long period. It may be argued that both taxes being of a temporary character ought to be added back, and this argument is a valid one so far as corporation profits tax is concerned. Excess profits duty is on a rather different footing because it was the concomitant of abnormally favorable trading conditions. It was, as its name implies, an impost levied upon exceptional profits; if those exceptional profits are brought into account, it would seem reasonable that the duty on them should be charged. On the other hand, the incidence of excess profits duty was by no means uniform, being dependent upon pre-war conditions and their effect upon the profit standard. On balance, I am inclined to the opinion that excess profits duty ought to be added back. It is common knowledge that the profits earned during the later years of the war and the post-armistice boom cannot be regarded as a true measure of earning power under present-day conditions.

"As regards all forms of taxation, the essential thing is that your Report, which may take the form of a Certificate of Profits in a public prospectus, should state explicitly how taxation has been dealt with.

"Interest on borrowed money is another item that is usually added back in computing profits, because it is a financial rather than a commercial item. If a business is being investigated with a view to purchase, the purchaser should be warned that the profits as stated are subject to such financial provision being made as will be necessary for the conduct of the business. In the case of a Certificate of Profits for a prospectus, the fact that interest has not been charged should be stated, and regard should be had to the question whether the financial arrangements embodied in the prospectus are such that, under normal conditions, the borrowings which have been necessary in the past will be non-recurring. Interest receivable from investments and bank deposits has to be considered in the light of the probability or otherwise of its continuance in the future.

"The remuneration of proprietors or directors is sometimes added back, and has to be considered mainly from the same standpoint as interest on borrowed money, namely, whether and to what extent it will have to be provided for in the future. In this connection attention should be given to service agreements which may have to be continued or commuted, and so far as these involve a charge against future profits in the shape of salary or commission, or both, they will have to be taken into account, either by deduction from profits, or by way of an explicit note of their existence and of their terms."
"Unless the business which is being examined includes the purchase and sale of investments, any profits or losses on realization which may have arisen should be disregarded, as they may be considered as something entirely apart from trading. It would not, however, be right to disregard losses on investments, where they have been acquired as a condition of obtaining business. For example, a customer may place a valuable contract on condition that the contractor takes payment, wholly or in part, in debentures or shares, or agrees to subscribe for them. The debentures or shares may prove valueless, or be sold at a loss, and in such a case it should not be fair to treat the profit on the contract as part of the normal earnings, and to disregard the loss on the compulsory investment.

"Depreciation is sometimes a difficult item, not only because it calls for some technical knowledge, but also because the provision made for it is apt to be of an irregular character. It is often the case that companies make no provision under this head when they are doing badly, but set aside large sums in good times. They may mean that the actual wear and tear bear no sort of relation to the provision made for them in the accounts. In such cases it may be necessary to ignore the provision which has been made in the accounts, and to recompute the depreciation in accordance with fixed percentages. It is sometimes advisable to obtain technical advice as to the percentages of depreciation which ought to be charged in any particular business.

"In order to be of value as a guide to investors, the profits stated should be those made in the ordinary course of business. They should be real and not theoretical profits. If profits have been augmented as the result of transactions of an exceptional nature or transactions outside the ordinary scope of the business, you may have to consider how far it will be right to include them and if included whether they call for special reference. On the other hand, you may find that there have been exceptional losses of a non-recurring character or losses due to speculative transactions which should not, and need not, form part of future operations. If you are satisfied that the business can for the future be safeguarded against such losses, you may be justified in not deducting them. In nearly every case, however, it will be necessary for your report to indicate that such losses have occurred.

"It is impracticable to lay down any hard and fast rules, as both exceptional profits and losses have to be considered in the light of the circumstances of each individual case. The only general guide which I can give you is to put yourself in the place of the investor who is to be guided by your report and to consider whether, and to what extent, your own judgment would be affected by disclosure of the facts as you know them.

"As an example of theoretical profits, I recall the case of a large company which had recently opened a factory abroad. Certain valuable contracts, on which it was estimated that a large profit could be made, were transferred to the foreign factory. Credit was taken in the books of the parent concern for this large profit as if it had been earned. The book value of the foreign factory was written up by a like amount because the profit the home concern would lose by the transfer was regarded as part of the cost to it of establishing the foreign business. I was reporting on the business of the company with a view to a debenture stock issue, and disclosure of the entries I have mentioned led to the immediate abandonment of negotiations.

"It was not uncommon, some years ago, for a prospectus to obtain a certificate of average profits without stating the profits for each year."
The effect of this was, that results of a fluctuating and irregular character, or showing a downward tendency, might yield over a selected period a respectable average of earnings, affording an apparent margin of security for debenture interest or dividends. The unreliability of the average would be disclosed if the true character of earnings year by year were stated. The practice is one which ought never to have been countenanced by Chartered Accountants, and it is satisfactory that it is not often met with at the present time.

"The ideal statement of profits consists of steadily improving results, and there is a natural desire on the part of vendors to show good figures in the later years. It is to these years, therefore, that the closest attention should be directed.

"Many a profit statement as originally prepared does not truly reflect earning capacity, inasmuch as the allocation of items which overlap one or more periods is not always made with due care. It may be found that by an equitable distribution of the profits of long-term contracts, or, on the other hand, of bad debts or special items of expense over a series of years, the true course of profits can be shown to be quite different (either better or worse) from what it appears to be in the accounts originally submitted.

"I have indicated that the profits as stated in your report may differ materially from those shown by the accounts submitted to you. I need hardly emphasize the importance of having among your working papers a clear reconciliation statement, beginning with the profits as submitted, and showing all the adjustments which have led up to the figures in your report. It is not enough that the adjustments you have made should be clearly shown; it is essential that you should know, not only at the time but, if necessary, years afterwards, why you made them. This implies the reasons, where they do not lie on the surface, for any modifications you have made of the figures submitted to you.

"An accountant's certificate of profits is now usually accompanied by a statement of assets and liabilities. Such a statement is often a resume of the last Balance Sheet, and the only responsibility which an accountant takes in regard to it is that it is in accordance with the books. It is no part of an accountant's duty to certify the values of fixed assets, and when it is desired that the valuation should be supported by something more than book values, it is usual for a professional valuer to be employed. His valuation can be substituted for book values, and the statement of assets would then show how far the figures are based on the valuation and how far on book values.

"In regard to the professional valuation, a good deal of trouble may be saved if, at the outset, instructions are so given to the valuer as to ensure his valuation being made in such a way that the result can be compared with book values. This may entail some analysis of the capital expenditure accounts in the books. For example, the valuation may relate to land, buildings, and fixed plant, whereas the books may not distinguish between fixed plant and loose plant, which latter may include tools. The classification in the books may not accord with that which a valuer would adopt in the absence of special instructions. It will be well, therefore, to ascertain and, if possible, to direct, the line upon which the valuation is to proceed, so that book values may be brought into relation with it by grouping or analysis of the corresponding capital expenditure accounts. Having regard to the relatively high fee charged by valuers in respect of
loose plant and tools, these last may with advantage be valued by qualified officials of the business. What you have particularly to guard against is, getting the same thing twice over in the statement of assets, first as part of the valuation, and secondly as a balance shown by the books.

"Although you are not expected to take full responsibility for book values, it will be your duty to indicate in your report any doubt which you may have as to the correctness of the way in which book values have been stated. If, for example, in your opinion, insufficient provision has been made for depreciation, it may be desirable for you to state what rate of depreciation has been allowed, or you may have to go further and state that the rate of depreciation appears inadequate.

"The assets should be set out clearly under appropriate headings and not lumped together indiscriminately, and, in particular, the book values of intangible assets, such as goodwill and patent rights, should be separately shown.

"The verification of assets and liabilities in the case of an investigation differs in general but little from the procedure which would be adopted in the course of an audit. The careful scrutiny of capital expenditure which forms part of an audit cannot be omitted from an investigation programme.

"The value of a statement of assets and liabilities is that it furnishes an investor with material for an opinion on the security for his capital. Where an issue of debentures or shares is being made it is usual for the proceeds of the issue, after deducting expenses, to be added to the net assets in order to show what the position will be after the issue has been made. Conversely, if dividends have been paid since the date to which the statement was made up they should be deducted.

"In the debenture prospectus the assets are sometimes stated at their gross amount without deduction of liabilities, in the ground that a debenture-holder has priority over all other creditors. This is in my opinion unsound, because it is quite possible for the assets to be reduced by paying off unsecured liabilities before a debenture-holder is in a position to appoint a receiver. In the case of a debenture issue, the security for which is conferred wholly or in part, by a floating charge, it is possible for the company to pledge its assets specifically to other parties, thereby diminishing the assets of which a receiver for the debenture-holders could obtain possession.

"Under present conditions issues of shares and debentures by companies are frequently made by, or with the assistance of, financial houses. The issue may be underwritten by the issuing house, or it may be purchased outright and sold to the public. Conditions have in recent years shown a marked improvement as compared with the old days when a promoter would get an option on a business, with a view to selling it to a company and without caring to know much more about it than that it showed sufficient earning power to justify a capitalization which would give him a good profit on the option price.

"Financial houses of the best class are careful not to associate themselves with issues which are unlikely to do them credit. It is not at all unusual for them to require something much more elaborate than a certificate of profits and net assets. They often stipulate for an exhaustive report, the proportion of which calls for the exercise not only of an accountant's knowledge of figures, but of the judgment and experience of a business man. They will often be glad to have an expression of opinion by an investigating accountant on the sufficiency of the financial provision to be made by the contemplated issue, and of the appropriateness
of the form it is to take. The preparation of such a report is a matter of the greatest interest and casts a heavy responsibility upon the investigator. It will help you to acquire the right attitude of mind if you regard yourself as a possible purchaser of the business. Ask yourself what are the things you would wish to know if you were acquiring the business or financing it. Be sure that you elicit the fullest information possible in regard to all such matters, and that you bring it to the notice of your clients. If any information is withheld, it will be your duty to make them aware of the fact.

"The work of an investigation which has for its object the amalgamation of several businesses of a similar character calls for the exercise of a great deal of judgment. It is necessary in such a case, to bring all the factors to a common denominator. So far as possible, profits should be computed and assets should be valued on similar lines in all cases, and the process of reducing the several businesses to parallelism in this respect may involve a series of elaborate adjustments. Differences cannot always be eliminated, and so far as this is the case it will be necessary to make allowances for them. You will have to take into consideration the financial constitution of the various undertakings which are to be associated. You may have to make recommendations not only as to the value of each concern or of that particular class of its capital which is to be acquired, but also as to the way in which the purchase money can be satisfied appropriately.

"In the case of a business which is marked by stability of results and the solidity of its financial position, the payment of considerable portion of the price in debentures would naturally be suggested. Net liquid assets are often paid for in preference shares. Where the principal value to be acquired consists of goodwill, ordinary shares may be more appropriate, since it would be unfair to saddle the combined undertaking with a mortgage debt and fixed annual charges, unless those who were to receive them were bringing tangible assets into the common pot. In general, you may take it as a principle that the income estimated as receivable from the new securities allocated to each business should bear a fair relation to its earning power. The total purchase money to be paid should be represented by net assets to be acquired, and goodwill.

"A word of caution in regard to goodwill may not be out of place, since goodwill is often inherent in the persons conducting a business rather than in the business itself. To estimate goodwill at so many years purchase of the average profits of past years would be fallacious, so far as the conditions which produced those profits will not continue in the future. Inquiry into the personalities of those who have been responsible for the past conduct of the business and into the arrangements which are being made for continuity of their services, may elicit information of much importance to an intending purchaser.

"A certificate of profits and assets in a prospectus, or a report on a business, is often the prelude to an important financial operation. It behooves you, therefore, throughout your investigation, to retain a sense of responsibility. It is not at all unusual for a purchaser to be disappointed with his purchase, or for a company to fail to fulfill the anticipations held out in the prospectus, or even to live up to its record. The management may be at fault, or new conditions subsequent to your report may have arisen, but there is a human tendency to attribute failure to defects inherent but undiscovered at the time. There may be a disposition to blame the accountant and question the statements for which he was responsible. The longer the interval which has elapsed before any question is raised, the more difficult will it be to furnish justification,
unless you can turn to your notes for evidence that due care and diligence were exercised. Statements upon which you relied, and reason upon which you acted, may have been perfectly clear at the time, but the intervention of many other matters during a period of years may blot out or impair recollection and in default of proper records you may find it impossible to justify your action. It is also well to bear in mind, in justice to your employer, if you are working as a clerk and not as a principal, that your yourself may not be available to furnish the necessary explanations when occasion arises, and that unless you leave behind you a well-ordered set of papers containing the necessary records, you may be putting him in an unnecessary difficulty, and exposing him to an avoidable risk.

"In framing your report you should aim at lucidity and completeness. To achieve completeness without prolixity some little ingenuity may have to be exercised. Your report should contain a reference to all salient points, and in order to keep the report itself within reasonable limits you may transfer details and amplifications into schedules which may include the accounts upon which you are reporting. The report itself should be broken up into sections, and each section into sub-headings, with reference to schedules from which more detailed information can be obtained. The schedules should be arranged in the same order as the corresponding sections and sub-sections of the report itself. Each subject, so far as possible, should be dealt with in logical sequence and disposed of. Your object should be to bring to your client's notice, in the smallest possible compass, all the important points covered by your investigation. You should avoid wearying him with a mass of detail from which a salient point emerges here and there. At the same time, for the sale of fullness of information, and possibly for your own protection, it may be necessary to state in some detail the scope of your investigation, the means of verification which you have adopted, and the limit of your responsibility, but you should be careful to do it in such a way as not to obscure your main conclusions.

"Use explicit terminology; do not refer to the same thing by different names; be sure that your words convey no more and no less than you mean them to convey; avoid ambiguities; do not be afraid to repeat a word or a phrase if the repetition will avoid risk of misinterpretation; cultivate literary grace if you can, but do not let desire for style interfere with accuracy.

"In conclusion, cultivate the power to see things as they are, the faculty of stating facts and opinions lucidly, and, above all, a habit of fearless honesty of purpose. It is not enough to be honest if you yourself are liable to be easily misled; it is useless to allow yourself to be persuaded (perhaps against your better judgment) into taking a course which may mislead those who rely upon your skill and reputation."
1. On investigations what constitutes the most important single aspect of the auditor's skill? When may an auditor use the reports of other auditors?
2. What responsibility is assumed by using them?
3. Why should the explanation of adjusting entries be very complete?
4. Why should the auditor ascertain and present the complete facts on all leases held by the client?
5. What sort of auxiliary information should the auditor present? Illustrate.
6. Show definitely how a knowledge of the time and amount of the "peaks" of such items as inventories, accounts receivable, etc., is valuable to a credit man or to a banker.
7. Why should the Auditor's Report itemize and comment fully on the Deferred Charges?
8. Why is it important for the auditor to comment on the adequacy of the bookkeeping system and cost system, if any?
9. Explain the meaning and value of each of the 25 ratios given in the test.
10. Why should the Working Papers on investigations be very full?
11. What worth while facts on customers, in addition to those mentioned in this chapter, could an auditor assemble on an investigation?
12. How should sales of raw material be handled?
13. Why is it that some prospective purchasers are more interested in the net sales than in the net profit?
14. Give several points on Working Papers that need to be covered on investigations.
15. When an appraisal is going to be made, what should the auditor do about it, if anything?
16. On investigations, to what scope should an auditor limit his Auditor's Report?
17. Why, on investigations, should the auditor have a somewhat longer and more careful interview with the client than in the case of ordinary audits?
18. If an investigation is being made by the client for a certain party, what in particular should the auditor do that he would not otherwise do?
19. On investigations why is it especially desirable to make out a Memorandum of Engagement and also send a Letter of Engagement to the client?
20. How long should Working Papers on investigations be preserved?
21. What problem in connection with PARTNERS' SALARIES may arise?
22. What position should the auditor take in regard to happenings which occur AFTER the audit date?
23. Should an auditor certify to an average profit?
24. Why is it dangerous to eliminate "unusual" expenses?
25. Why is it desirable for the auditor to present a comparative Profit and Loss Statement?
26. Prepare a STATEMENT OF APPLICATION OF FUNDS.
27. List the important points which Mr. L. A. Hawkins, F.C.A., brings out in his article, INVESTIGATIONS.
28. Prepare an ANALYSIS OF GROSS PROFIT.
29. What is the auditor's duty when stating profits before interest, depreciation, depletion, and/or etc., have been deducted?
30. Why should quantity units be tied in with the profit and loss, and the balance sheet figures whenever and wherever this is possible?

31. What were the points stressed in the section on ESTIMATES?

32. A Co. contends that the declaration of a dividend and the fixing of the dates for the stockholders of record and for its payment does not create a debt unless a fund is set apart for its payment. Is A Co. correct? Why?

33. A Co. contends that, having declared a dividend to stockholders of record of a certain date, but with no date of payment, it may repudiate such dividend. Is A Co. correct? Why?

34. A Co. maintains that it may take the dividend of a stockholder in payment of a debt due from him to the corporation, or as an offset to an assessment. Is A Co. correct? Why?

35. A Co. declared a dividend payable March 1, but did not set aside a special fund therefor. On March 6 the company became insolvent by reason of certain losses. As a consequence after March 6th A Co. refused to give the dividend checks to the stockholders who had not as yet called for them. The stockholders maintain that they are preferred creditors. Is A Co. correct? Why?

36. A Co. sets aside with the B Bank a fund to pay a declared dividend and then withdraws the funds. Is A Co. acting within its rights? Why?

37. A Co. maintains that if a dividend, declared out of capital, has been distributed to the stockholders it cannot be reclaimed. Is A Co. correct? Why?

38. A Co. maintains that it hasn't the right to rescind a stock dividend at any time prior to the actual issuance of the stock. Is A Co. correct? Why?

39. A Co. maintains that it has the right to rescind a treasury stock dividend at any time prior to the actual issuance of the stock. Is A Co. correct? Why?
CHAPTER 47

THE POWERS, DUTIES AND LIABILITIES OF
DIRECTORS, OFFICERS AND STOCKHOLDERS

794. Introductory Comment.
796. Remington’s Compiled Statutes of Washington.
797. De Facto Directors.
798. Chicago Title and Trust Co. v. Niday.
799. Unity of Action.
800. Cheney v. Lafayette, B & M R Co.
801. Authority of Officers.
802. Pink v. Metropolitan Milk Co.
803. The Lord Kylsant Case.
804. Minnesota Loan & Trust Co. v. Peteler Car Co.
805. Abstracts from Ohio Corporation Law.
807. Compensation of Directors.
808. Director’s Right to Inspect Corporation Records.
809. Rights and Liabilities of Stockholders.
810. McLaren v. Crescent Planing Mill.
813. State v. Pacific Brewing & Malting Co.
814. Answers to A.I.A. Questions.

Review Questions.

794. Introductory Comment.—The subject matter of this chapter will be developed chiefly through citations from cases at law taken from “Ayer and Ashley” or from “Collins.” Much of it is repetition, but that fact will simply serve to drive the various points home, it is hoped.

795. Continental Securities Co. v. Belmont.—“The board of directors represents the corporate body. It is provided by statute in this state that the affairs of every corporation shall be managed by its board of directors. General Corporation Law (Consol. Laws, 1909, c.23), section 34. The directors are not ordinary agents in the immediate control of the stockholders. The directors hold their office charged with the duty to act for the corporation according to their best judgment, and

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1 Court of Appeals of N Y 1912-206 N Y 7,99 N E 138,51 LRA (N.S.) 112 Ann. Cas. 1914 A777
2 Supreme Court of Ill. 1921-397 Ill 555,131 N E 103
3 Supreme Court of Ill. 1873-68 Ill. 570, 18 Am. Rep. 584
4 Supreme Court of Minn. 1916-129 Minn. 353, 158 N.W. 275
5 Supreme Court of Minn. 1916-132 Minn. 277, 156 N.W. 255
6 Chancery Div. Vol. 36, p.787 (1887)
7 St. Louis Court of Appeals, Co. 1906, 117 Mo. App. 40, 93 S W 819
8 97 Conn. 364, 116 Atl. 600
9 113 Me. 265, 93 Atl. 754
10 Supreme Court of Wash. 1899, 21 Wash 451, 58 Pac. 584, 47 LRA 308
in doing so they cannot be controlled in the reasonable exercise and performance of such duty. The corporation is the owner of the property, but the directors in the performance of their duty possess it and act in every way as if they owned it. (Citation.) They are trustees clothed with the power of controlling the property and managing the affairs of a corporation without let or hindrance. As to third persons they are its agents, but as to the corporation itself equity holds them liable as trustees. (Citations.)

"As a general rule, stockholders cannot act in relation to the ordinary business of a corporation. The body of stockholders have certain authority conferred by statute which must be exercised to enable the corporation to act in specific cases, but, except for certain authority conferred by statute, which is mainly permissive or confirmatory, such as consenting to the mortgage, lease, or sale of real property of the corporation, they have no express power given by statute. They are not by any statute in this state given general power of initiative in corporate affairs. Any action by them relating to the details of the corporate business is necessarily in the form of an assent, request, or recommendation. Recommendations by a body of stockholders can only be enforced through the board of directors, and indirectly by the authority of the stockholders to change the personnel of the directors at a meeting for the election of directors.

"The claim of the appellants that the body of stockholders has some immediate or direct authority to act for the corporation or to control the board of directors in the matters set forth in the complaint is based upon an erroneous conception of the duties and powers of the body of stockholders in this state."-Chase, J.

796. Remington's Compiled Statutes of Washington.-- "The authority of the directors or trustees is restricted to the management of the regular business affairs of the corporation and does not extend to changes in the character or organization of the corporation. Fundamental changes in the corporate body, such as increase of the capital stock, consolidating with another corporation, selling out the property, or altering the by-laws, are matters for the stockholders rather than the trustees or directors. Also, matters of exceptional concern, for example, bond issues, are usually referred to the stockholders for their approval, although the directors may have the power to act.

"The stockholders may indirectly control the directors through the power of removal and election. However, directors elected for a certain term of office may not be removed during the term except for cause unless provided otherwise by charter, by-laws, or statute. For example, in Washington two thirds of the stockholders may expel a director at any time."

797. De Facto Directors 1. -- The acts of de facto directors are generally valid as between the company and third parties dealing with them in good faith as directors and in ignorance of the fact that they are not de jure directors.

798. Chicago Title and Trust Co. v Munday.-- "The responsibility of members of a board of directors of a bank is discussed in Briggs v. Spaulding, 141 U.S. 132, 11 Sup. Ct. 924, 35 L. ed. 662, wherein it is said: "Without reviewing the various decisions on the subject, we hold that directors must exercise ordinary care and prudence in the administration of the affairs of a bank, and that this includes something De facto directors are ones who are not properly or lawfully qualified to act in their said capacity.
more than officiating as figureheads. They are entitled under the law to commit the banking business, as defined, to their duly authorized officers, but this does not absolve them from the duty of reasonable supervision, nor ought they to be permitted to be shielded from liability of want of knowledge of wrong doing, if that ignorance is the result of gross inattention.

"The charges contained in the amended bill were that these defendants gave no supervision and made no inquiry whatever, notwithstanding they were directors of the bank and had knowledge of the incompetence and dishonesty of Lorimer and Munday and their fraudulent misuse of the funds of the bank. To say that such a charge in a bill is not sufficient to hold directors liable, if proven, would be to render indeed hazardous the deposit of money in banks. Were we to hold that directors of a bank are required only to exercise slight care, or that when elected as directors they may become what is characterized by the Appellate Court as "inactive" members of the board, who may give no attention whatever to the business of the bank, but be mere figureheads, few persons would be willing to deposit money with or take stock in such corporations. It is a matter of common knowledge that men of strong financial ability are asked to serve as directors of banks because of the feeling of security which the public will have from their connection with the corporation. That feeling of confidence arises out of the fact that the public, when depositing money in a savings bank, or when taking stock in the corporation and divesting themselves of control of their property, expect, and have a right to expect, that the men selected as directors of a bank to control the property will exercise ordinary care and prudence, and when one takes a position as director of a bank he becomes trustee for the depositors as well as for the stockholders, and is bound to the observance of ordinary care and diligence, and is hence liable for injury resulting from the nonobservance, where such nonobservance is due to the negligence of such director."--Stone, J.

799. Unity of Action.-- The Board of Directors must act as a Board, for the separate action of individual directors is not the equivalent thereof. Moreover, in the absence of written waiver spread upon the corporate records, proper notice must be given of the time, purposes and place of all meetings of the Board.

800. Cheeney v Lafayette, B & M R Co.-- "In the case of Dustin v. The Imperial Gas Co., 3 Barn. & Adol. 125, it was held that, whilst agents and employees might, perhaps, recover for services rendered for a corporation, a director could not, unless provision therefor had been made by resolution having the force of a by-law, or by such a by-law. And it was said that such officers differ materially from mere agents and employees; that directors are managers or governors, and not agents.

"No person is under the slightest compulsion to accept the position, and if he is unwilling to do so without compensation, public policy requires that his compensation should be fixed and certain before he enters upon the discharge of the duties of his office. This rule must apply to services rendered by persons holding the office of directors, who have the control of the funds of the body. But a person not a director, and having no control over the funds and property of the corporation, rendering services, does not occupy the relation of trustee to the company, and does not fall within the rule, and may recover a reasonable compensation for services rendered. The law has never conferred on trustees the authority to profit by the exercise of the powers and duties of their position."
"This, then, disposes of the claim of appellant for services rendered as a director of the company. But the question arises, whether or not he rendered services for the company which do not pertain to his duty as director, and if so, whether he may recover a fair compensation for such service.

"Because he was a member of the board of directors, it does not follow that he was bound to perform any and all duties usually exercised by agents properly appointed, and when he performed such duties under an appointment by a resolution of the board, he should be allowed compensation therefor. Where an attorney is employed to attend to the general or special affairs of the company, he should be compensated. So of a secretary or a clerk, and an agent to solicit subscriptions and to procure the right of way, etc.

"It would, then, follow, that, as appellant was appointed to solicit subscriptions of stock, and to procure the right of way for the road, he may recover, unless that duty was imposed on him as director by the charter or the by-laws. In performing those duties, it is more than probable that he acted as an agent, and not as a director, and should be permitted to recover for such extra service, but if this duty was imposed by the charter or the by-laws of the company as a director, then a recovery could not be had therefor. The duties he performed as a member of the executive committee in making efforts to contract for the construction of the road, including time and travel, were a part of his duty as a director, and from the authorities above referred to, he has no right to recover for them. Nor is it an answer to say that the company could have intrusted the duties of the executive committee to others not directors or even stockholders, and paid them a fair compensation for their time and skill. They had the power to so act as directors, and they, as directors, or as a part of them, performed the services."--Walker, J.

801. Authority of Officers.-- In brief, the officers of a company have (a) the authority conferred upon them in the charter, by-laws, and resolutions of the Board of Directors and/or of the stockholders; (b) the powers which the company professes they have or knowingly allows them to assume; and (c) such implied powers as are necessary to permit them to carry out their express powers.

802. Pink v. Metropolitan Milk Co.-- "It is so rarely necessary to say that a corporation may hire a bookkeeper and accountant without resolution or other direct act of the board of directors. Officers or agents may be vested with this power. (Citations.)

"The power to hire such an employee or to authorize an agent to do so is presumably incident to the position of general manager of a commercial corporation."--Hallam, J.

803. The Lord Kylsant Case.-- "In the court of criminal appeal, London, on November 4th, the appeal of Lord Kylsant was dismissed. Thus ended a case which attracted a great deal of attention in many parts of the civilized world, and it will doubtless go down in history as a leading case altogether apart from the prominence of the accused. Baron Kylsant was tried and convicted in the Central criminal court last July on charges which involved the publishing in 1928 of a false prospectus, for the purpose of floating an issue of debenture stock by the Royal Mail Steam Packet Company, of which he was chairman. The penalty imposed by the court is twelve months' imprisonment in what is known as the second division, in other words imprisonment without hard labor.
"The conviction was based chiefly upon the alleged falseness involved in the statement of average. Some point was made during the trial of what might have been revealed had the earnings been allocated year by year, but while this would have given the prospective investor the information to which he was entitled it would not have affected the average, which was apparently quite truly presented. Indeed in his summing up Justico Wright, of the Central criminal court, said:

"'If . . .adjustments had been made putting into the earlier years all those matters which were afterwards brought into the later years . . . still the average would not have come out anything different or at all substantially different. That is, of course, obvious. If you take an average you may within the period over which the average is taken have very diverse figures and I should imagine—I do not know, but one feels—that if ever I venture on a prospectus in future I shall look very shyly indeed at any reference to averages.'

Everyone who is interested in even the most remote way in the financial statements of companies is concerned with the manner of the presentation of facts, so that these facts shall be illuminating and shall not becloud the issue. It seemed, therefore, important that the courts called upon to decide in the case of Rex vs. Kylsant should render their opinion in no uncertain way. It is most disappointing to learn from the record now available that the court of criminal appeal for some reason not clearly manifest confirmed the conviction on a different issue. It almost seems as if the court had felt a doubt as to the propriety of a conviction based upon the falsity conveyed in a statement of fact but, feeling that justice demanded conviction, had confirmed the decision of the lower court on a collateral argument. When rendering judgment in the court of criminal appeal Justice Avery said, in part:

"'In the opinion of this court there was ample evidence on which the jury could come to the conclusion that this prospectus was false in a material particular, in that it conveyed a false impression. The falsehood in this case consisted in putting before intending investors, as material on which they could exercise their judgment as to the position of the company, figures which apparently disclosed the existing position, but in fact hid it. In other words the prospectus implied that the company was in a sound financial position and that the prudent investor could safely invest in its debentures. This implication rises particularly from the statement that dividends had been regularly paid over a term of years, although times had been bad—a statement which was utterly misleading when the fact that they were paid, not out of current earnings, but out of funds which had been earned in the abnormal war period, is omitted.'

This seems to indicate a somewhat different course of reasoning in confirming the sentence from the basis of the conviction rendered by the lower court. In a word, it seems that an important precedent as to the interpretation of true statements so arranged as to mislead is seriously weakened by confirmation upon a different ground. It is not the same thing to state average earnings and to declare dividends over a series of years out of earnings which may have accrued in one year of the series. It is not at all uncommon to find corporations reserving a sufficient amount of earnings to meet dividend requirements of lean years; and, while the practice is not altogether commendable, it is not necessarily fraudulent. It may be quite excusable if a frank statement of the time of earning accompanies the declaration of a dividend of earnings. It would have been more helpful if
the issue in the Royal Mail case had not been confused as it was."

"... ... It remains for an accountant to express the matter in a most terse and incisive way. At a meeting in the guild hall at Hull, England, Henry Morgan, president of the Society of Incorporated Accountants and Auditors, referred to the Royal Mail case at some length. In the course of his remarks he used the following expression, which seems to us to sum up the whole matter:

"It should be borne in mind that a secret reserve can arise only through an understatement of profit, and in no other way, and it can not be denied that balance-sheets or profit-and-loss accounts which are affected by secret reserves are untrue to the extent of such reserves."

The following paragraphs contain the comments of three well known men on the subject of secret reserves.

(1)

"Hidden reserves may be created in good faith and in bad faith. There are occasions when they may be severely condemned or heartily approved. It all depends upon the circumstances and motives of the individual case. Hidden reserves may be useful and advisable in close corporations where all of the stockholders are also officers and know what is going on. Thoro is a great deal loss defense for secret reserves in large concerns. This (disclosing all facts) seems to be good ethics and, as far as I can see, sound common sense, as well as good accounting practice." — J.T. Madden.

(2)

"... While I strongly believe that reserves for those and any other proper purposes should be plainly set forth on the balance sheet, I can readily see why a management might for perfectly legitimate reasons prefer to hide them so that they would not be apparent.

"Stockholders are an importunate, often greedy, and sometimes unruly crew. It is to prevent both of these things ("blooding" the company in prosperous times; wailing if dividends are passed in depressions) that management often hides a concern's actual earnings and the resulting reserves.

"But on the whole I believe the practice of hiding reserves does more harm than good. The existence of hidden reserves provides strong temptation for insiders to capitalize on their knowledge by speculating in the company's stock and even for downright crookedness."

"My personal view is that the information given to competitors by a clear, accurate, detailed statement can do little or no harm. A strong able management should be able to withstand the complaints of stockholders. Therefore, while I advocate ample reserves for all contingencies, I prefer to see them set up clearly and not hidden in the best interest of the company, its stockholders, prospective investors and those from whom it may want to secure credit." — F.A. Smith.

(3)

"... Conservative balance sheets must not be confused with inaccurate or deceptive balance sheets. The former is good business, while the latter may constitute fraud, according to the last Ultramarines decision. If balance sheets are prepared so that the layman may learn the facts about the financial condition of the business, there cannot be criticism if values are conservatively stated. If prepared so that the average layman cannot understandably read without the assistance of an accountant, there is ground for criticism regardless of what values are used." — H.C. J. Peisch.

The defendants guaranteed the obligations of the company to the extent of $30,000, and upon the faith of this guaranty the First National Bank of Minneapolis loaned the company this amount. As security for their guaranty the company mortgaged to the defendants the Coma property. Afterwards, the company being unable to pay, the defendants paid the bank the $30,000, and they now claim the right to enforce their mortgage.

"The defendants were directors of the corporation. The directors of a corporation may loan the corporation money or pledge their credit, and take a mortgage for security, if they act fairly and in good faith and without wrongdoing others. The defendants acted fairly and in good faith and did no wrong. Our court has stated the rule to be this:

"Directors and other officers may deal with the corporation they represent, and of which they are members, precisely as though they held no official relation with it, and contracts entered into by them with the corporation are valid and enforceable so long as not tainted with fraud. In such transactions the directors are bound by those rules of fairness which courts of equity impose upon trustees, but they are not forbidden to loan the corporation money, or from guaranteeing the payment of its obligations." Savage v. Madelia Farmers' Warehouse Co., 98 Minn. 343, 108 N.W. 296.

"Undoubtedly his relation as a director and officer, or as a stockholder of the company, does not preclude him from entering into contracts with it, making loans to it and taking its bonds as collateral security; but courts of equity regard such personal transactions of a party either of these positions not, perhaps, with distrust, but with a large measure of watchful care; and unless satisfied by the proof that the transaction was entered into in good faith, with a view to the benefit of the company as well as of its creditors, and not solely with a view to his own benefit, they refuse to lend their aid to its enforcement." Richardson v. Green, 133 U.S. 30, 10 Sup. Ct. 280, 33 L. ed. 516. But it is urged that the mortgage is voidable without a showing of fraud or bad faith or breach of fiduciary duty or resultant injury because the mortgagors were directors, and took part in the transaction which resulted in the making of it.

"The mortgagees were a majority of the directors. They participated in the meeting of the directors which authorized the mortgage, and the presence of a majority of them were necessary to a quorum. Some of the cases make a mortgage so executed void, but the weight of authority is not with them. Others make it voidable. Some of these make it voidable at the election of a corporation or of a stockholder, though fraud or breach of duty or prejudice are not present. This is the rule applicable to trustees and their cestuis. A purchase by a trustee is voidable at the option of the beneficiary without a showing of fraud or wrong or prejudice; and courts do not inquire into the honesty of a particular transaction or whether it is prejudicial to the beneficiary. (Citation.) Others make the mortgage valid if it is affirmatively shown that the transaction is fair, involves no breach of fiduciary duty, and results in no harm to the corporation or others nor undue advantage to the directors; and otherwise they hold it voidable. (Citations.)

"We take the rule to be that a transaction between the corporation and a majority of its directors acting in its execution, whereby they advance money or procure it to be advanced on their guaranty, and take security, if affirmatively shown upon close scrutiny to be fair and not to involve a breach of fiduciary duty and not to result in wrong, will
be upheld, and that if otherwise, it may be avoided. Such a transaction as is before us is not uncommon. Corporations find it necessary to borrow money. It is usual for directors to provide it. Often it can be provided only by their lending their credit. The rule stated and applied to loans of money or of credit by the directors is a sensible and an easily workable one. It is fair. It gives proper recognition to legitimate business uses. It strikes down dishonest corporate transactions, and does not hamper honest corporate business."--Diboll, C.

805. Abstracts from Ohio Corporation Law.--8623-121 "If any corporation shall commence business before there has been paid in the amount of capital specified in its articles as the amount of capital with which it will begin business, no corporate transaction shall be invalidated thereby, but the directors participating therein shall be jointly and severally liable for the debts of the corporation up to an amount not exceeding in the aggregate the amount of capital so specified in the articles until the amount of capital so specified has been paid in"

8623-123 "Any person, being an officer, director or employee or agent of a corporation who

"Shall make, issue, deliver, transmit by mail, or publish any prospectus, report, circular, certificate, statement, balance sheet, exhibit or document respecting the shares, assets, liabilities, accounts or any of them, capital business or dividends of a corporation which is false in any material particular, knowing such statement to be false, or shall knowingly participate in any such act; or

"Having charge of the books, records or accounts, or any of them, of a corporation, shall make or cause to be made therein any entry which is false in any material particular, knowing such entry to be false, or with intent to deceive, shall remove or alter any entry therein; or

"Having control or supervision of the issuance and transfer of shares of a corporation, shall, either alone or with another, with intent to defraud, issue or permit to be issued a certificate or certificates for more shares than have been duly authorized to be issued, or issue or permit to be issued to any person a certificate for more or less shares than such person is entitled to, or a certificate for any class of shares to which such person is not entitled

"Shall be personally liable, jointly and severally, with all other persons participating with him in any such act, to any person who is then or within one year thereafter becomes subscriber to or purchaser of shares, a shareholder or creditor of such corporation, or a pledge of any of its shares or securities, for any and all loss or damage actually suffered and caused in whole or in part thereby and resulting therefrom.

"No director shall be liable in any way for the act, omissions or defaults of any other director unless he shall knowingly concur or participate therein, and each director shall be entitled to rely and act upon the statements, reports and representations made to him by any other director, or officer of the corporation, or by a public accountant or firm of public accountants of good reputation, if he so acts and relies in good faith.

"And any officer, director or employee of a corporation may exonerate himself from any and all liability under this section by entering his objection and protest on the records of the corporation and giving notice in writing or by publication of such objection and protest to all persons known by him to have received any such prospectus, report, circular, statement, balance sheet, exhibit or document, or to have relied upon in any way or acted upon any books, accounts or records mentioned or described in this section.
"An action to enforce a liability created by this section shall not be brought after four years from the time the same shall accrue."

8623-124 "The directors of a corporation shall not pay dividends or withdraw or distribute any part of its stated capital except as provided in this act.

"In case of any wilful or negligent violations of the provisions of this section the directors under whose administration the same shall have happened except those who may have caused their dissent therefrom to be entered upon the minutes of such directors at the time or who were not present when such action was taken, shall be jointly and severally liable to the corporation at any time within two years after such violation for the full amount of any loss sustained by such corporation by reason of any such dividend, withdrawal or distribution.

"A director shall not be held to have been negligent within the meaning of this section, if he relied and acted in good faith upon a balance sheet and profit and loss statement of the corporation and a statement of the computation of the surplus available for dividends represented to him to be correct by the officer of the corporation having charge of or supervision over its accounts, or certified to be correct by a public accountant or firm of public accountants of good reputation and if he caused such balance sheet and statements to be entered on the books of account or record of the corporation."

8623-127 "Every corporation which shall neglect, fail or refuse (a) to keep and maintain or cause to be kept and maintained, or (b) to keep minutes of the proceedings of its incorporators, shareholders and directors, or (c) to prepare or cause to be prepared and cause to be certified the statement of profit and loss and balance sheet required to be prepared, or (d) fail, within three days after request, to mail such statement of profit and loss and balance sheet to any shareholder making request, or (e) to do any act required by this act to be done, shall be subject to a penalty of one hundred dollars ($100) and the further penalty of ten dollars ($10) for every day, beginning three days after written request, that such default shall continue, to be paid to any and all shareholders making such request, and the right of any shareholder to enforce the payment of any such penalty shall be in addition to all other remedies."

806. Loods Estate, Building and Investment Company v. Shophard.--

"The conclusion at which I have arrived, upon a consideration of the whole evidence, is, that the directors never exercised any judgment at all with reference to these accounts, but accepted without inquiry or verification whatever Crabtree and Locking told them. In this request they failed, as I think, to perform the duty cast upon them by the articles of association. That duty was to cause estimates of account to be prepared, and upon those estimates to recommend a dividend. In the performance of that duty they were no doubt entitled to avail themselves of the advice and assistance of their secretary and manager, and to obtain by that advice and assistance such materials as were proper for the purpose of enabling them to decide upon the questions they had to consider;"
and having so done they were bound to exercise their judgment as mercantile men on the materials which they had obtained. This, in my opinion, they never did; but in truth they delegated to Crabtree the exercise of that judgment and discretion which it was their duty to take upon themselves. Upon the whole, although the directors were, I believe, ignorant of the true state of the company's affairs, and although I find no trace of their having acted with the view of obtaining any improper benefit for themselves, I feel compelled to hold that they have fallen short of that standard of care which, having regard to the Oxford Case\textsuperscript{1}, they ought to have applied to the affairs of the company in the following respects: -(1) they never required the statement and balance-sheets to be made out in the manner prescribed by the articles; (2) they failed properly to instruct the auditor, or, at all events, to require him to report on the accounts and balance-sheets in the mode prescribed by the articles; and (3) they were content throughout to act on the statements of Crabtree without inquiry or verification of any kind other than the imperfect audit of the accounts by Locking. Those accounts and balance-sheets did not truly represent the state of the company's affairs; and that being so, I think that according to what is laid down in Rance's Case\textsuperscript{2}, the onus is laid upon them to show that the dividends they paid were paid out of profits. This upon the evidence before me they failed to do.\textsuperscript{3}

807. Compensation of Directors.-- Ordinarily the auditor will not bother himself about the director's fees. However, if the amount paid per director is very large, it may be advisable for him to see if the by-laws permit the payment, and to check on the presence of each director.

808. Director's Right to Inspect Corporate Records.-- A director is charged with more than a mere superficial knowledge of the Company which he helps to direct; therefore, the law gives him the absolute right to examine all of the corporate records, including the auditor's report. Only in rare instances, however, will the auditor mail his report to each of the directors in order to make certain that no one is denied access to it.

If the auditor is advising a director representing a minority interest, he should ascertain if the director is aware of his rights in this particular. Very often one finds that the "minority director" is given only piecemeal information by the "majority directors".

On the other hand, it must be observed that a director's right is a PERSONAL one. He cannot entirely delegate the inspection of the books and records to auditors, nor can he employ an unlimited number of auditors or extend the examination over an unduly long period of time, or make the inspection with undue frequency.

809. Rights and Liabilities of Stockholders.-- A stockholder has, of course, no title to the property of the company. He has no direct interest in it because the property actually belongs to the company, a separate legal entity. This, then, is an entirely different situation from that existing in partnerships.

(A) Among the stockholder's chief individual rights are the following ones:

(a) A right to a proportional share in the profits when/if dividends are declared by the Board of Directors.
(b) A right to purchase a proportional share of an increase in the same class of capital stock which he now holds.

\textsuperscript{1}35 Ch. D 502. \textsuperscript{2}Law Rep. 6 Ch. 104. \textsuperscript{3}Leeds Estate, Building and Investment Company v. Shepahers --Chancery Div. Vol. 36.
(c) A right to receive a proportional share of the assets remaining on dissolution, AFTER all creditors are paid off in full.
(d) A right to inspect stock and transfer books and records, under reasonable situations, for the purpose of safeguarding either his own personal interests or that of the corporation.
(Sometimes the right is enlarged by statute to an absolute one of inspection.)
(e) A right, at common law, to inspect the books and records of the company, provided it is for just and reasonable purposes and consistent with the best interests of the company.
(f) A right to vote his stock at any or all meetings of the stockholders as he sees fit.
   A proxy may be given if it is for a reasonable period and for a lawful purpose.
   Some states allow cumulative voting.
   Treasury stock may not be voted.
(g) A right to be notified of all stockholders' meetings.
(h) A right to prevent ultra vires acts by the corporation.

(B) Among the stockholder's chief rights in a collective capacity are the following ones:
(1) The right to amend the charter.
(2) The right to elect the directors.
(3) The right to adopt, repeal or amend the by-laws.
(4) The right to sell the whole corporation or any part thereof.
(5) The right to dissolve the corporation.
(6) The right to change the location of the principal office or place of business.
(7) The right to change the par value of the stock.
(8) The right to increase or decrease the capital stock (assuming the permission of the state).
(9) The right to lease or exchange all/any assets.

(C) Among the stockholder's chief liabilities are the following:
(a) A stockholder is not indebted to creditors for debts of the corporation if his stock is actually full-paid stock. If not full-paid, the difference between the sum paid in and the par value must be contributed to the corporation for the benefit of the creditors.
   Very often, however, state statutes provide for some sort a limited liability such, for example, as the duty to pay wages of employees for a certain period, etc.
   A by-law providing for individual liability not provided for in the general law or in the charter is void.
(b) A stockholder is liable to pay, when called, the unpaid balance of his subscription to a lawful issue of capital stock.

(D) Finally, we may note that: (1) a stockholder has no right to interfere in the management as long as the directors act in good faith, in the lack of which his rights must be exercised through a Court; and (2) a stockholder has no right to enter suit against a director for damages arising out of misconduct in office. The suit must be in the name of the corporation.

810. McLaren v. Crescent Planning Mill1—"The precise questions

1It may be interjected here that it has been held that a dividend is legal
if the officers, without the formal action of the directors, pay it, pro-
vided all stockholders later agree thereto. (C of G.R. Co v. C. T. Co 135 Ga.
472, 69 S.E. 708). Naturally the rights of third persons must not be over-
ridden thereby.
arising on the record calling for the opinion of the court are: First. Whether the mere declaration of a dividend by a solvent corporation under such circumstances as indicated creates a debt in favor of the stockholder and against such corporation for the amount of such dividend in the absence of further express action on the part of the board of directors, setting aside a fund out of which to pay such dividend. Second. Is it competent for such corporation, after having declared the dividend, to pay one installment thereon and to rescind and recall the installments thereof yet unpaid?

"Counsel for appellants presents the following definitions of the word "dividend" from the authorities cited: "A dividend is defined as follows: 'A profit set aside, declared by the board of directors of a corporation and ordered by them to be distributed among the holders of its stock.' 9 Am. & Eng. Law (2d ed.) p. 580. 'A dividend is a corporate profit, set aside, and ordered by the directors to be paid to the stockholders on a fixed date.' 2 Coo, on Corp. (4th ed.) p. 534. 'A dividend is a fund which the corporation sets aside from its profits to be divided among its members.' Anderson's Law Dictionary, p. 369. 'A dividend is that portion of the profits and surplus funds of the corporation which has been actually set apart by a valid resolution of the board of directors, or by the stockholders at a corporate meeting, for distribution among the stockholders according to their respective interests, in such a sense as to become segregated from the property of the corporation, and to become the property of the stockholders, distributively.' 2 Thompson on Corporations, p. 2126."

"Upon the words "set aside," "set apart," and "actually set apart," employed in the definitions above stated, the learned counsel predicated the argument that a resolution declaring a dividend is not sufficient to create a dividend, or in other words, to create a debt from the corporation to the stockholder thereon, in the absence of further action on the part of the corporation setting apart a fund out of which the dividend or debt is to be paid. It is insisted that such resolution declaring a dividend, as in this case, is but an expression of intention in that behalf, which, to constitute it effectual for that purpose, must be followed or accompanied with competent action as well, setting aside a fund out of which the dividend is to be paid when due, and until such fund is set aside for that purpose, no dividend has been declared, and no right thereto is vested in the stockholders, and therefore it is competent for the same authority to rescind or recall the former action in that behalf. In short, it is argued that a declaration of a dividend and the fixing of a time of its payment does not create a dividend in the absence of the setting apart a fund out of which it is to be paid. With this thought in mind, we have carefully examined the many authorities and find the fundamental idea running through every case save one to be that if the declaration of the dividend is fairly and properly made, out of profits existing at the time it is declared, the relation of debtor and creditor is thereby established between the corporation and the stockholders and the debt is thereby created against the corporation and in favor of the stockholder for the amount of the dividend due on the stock held by him. There can be no doubt that this idea pervades the entire adjudicated law on the subject. (Cites cited.)"

"All of the text-writers agree on this doctrine. (Citations.) And the doctrine is that a dividend is considered parcel of the mass of corporate property until declared and therefore incident to and parcel of the stock up to the time it is declared, and before its declaration, will pass with the sale or devise of the stock. Whosoever owns the stock prior to the declaration of a dividend owns the dividend also, but the moment the dividend is declared it becomes then separate and distinct from the stock and the dividend falls to him who is proprietor of the stock of which it was theretofore incident. In De Gendre v. Kent, L. R. 4 Eq. 283, such dividends
were happily likened to fallen fruit which does not pass with the sale or gift of the tree; the principle clearly established being that the act of declaring the dividend operates as a severance thereof from the stock, and as said in Missouri Baptist Senitement v. McGuno, 112 Mo. App. 332, 87 S.W. 95, the time the law fixes in adjusting the ownership of dividends is the time when the dividends were declared, and thus severed from the stock of which they are therefore treated as incident. Under the foregoing principles, a specific legatee of corporate shares is entitled to all dividends which are declared after the death of the testator. (Citations.) A transfer of stock passes, of course, all dividends declared subsequent to the transfer although the dividend was earned before the transfer was made. A legatee of shares takes the stock as it was at the time of the testator's death. All dividends declared previous to that event go to the administrator. (Citations.) And upon the principle that the declaration of the dividend operates as a severance thereof from the stock in the general mass of the corporate property and arises from such declaration an implied promise on the part of the corporation to pay the stockholder the amount of the dividend, it has been adjudicated that when moneys for the payment of such dividend are not set apart for the payment thereof, but are permitted to remain still in the corpus of such corporate estate after the declaration, the stockholder stands as a general creditor of the concern in bankruptcy who can come in only ratably with such creditors, looking to the general estate for liquidation of his dividend debt. (Citations.) While, on the other hand, the converse of this principle has been stated and applied in cases where the dividend has been declared and a fund set apart out of which to pay the same. Under such circumstances, it is held that such action on the part of the corporation in setting aside a fund for the specific purpose constitutes such moneys a trust fund in the hands of the corporation for the use of the stockholders, and in event of the bankruptcy of the corporation, the stockholders are not required to go in pro rata with the general creditors for such unpaid dividends, but may proceed as against a trustee on account of such trust fund and recover the whole of their pro rata thereof. (Citations.) Wherefore it appears that the principle obtains that the mere declaration of the dividend, without more, by competent authority under proper circumstances, creates a debt against the corporation in favor of the stockholder the same as any other general creditor of the concern; whereas, the setting apart of a fund after or concurrent with the declaration, out of which the debt thus created is to be paid, passos one step further toward securing the payment of the identical fund to the shareholder in as much as the law treats the setting apart of such fund as a payment to the corporation as trustee for the use of the stockholder, on which fund the stockholder has a lien, and to which fund he has rights superior to the general creditor. From these considerations we are persuaded that the mere declaration of the dividend itself, without the setting aside of the fund, creates a debt and that when the learned text-writers, supra, employ the terms "set aside," "set apart," and "actually set apart," as above pointed out, they proceed upon the theory and principle supra, that the act of declaring a dividend, operating as it does, as an actual severance of the dividend from the stock and corpus of the corporate property and estate, is ipso facto, in and of itself, the setting apart, setting aside, and segregating such dividend in the sense that it creates an immediate right of the stockholder to demand and recover the same when due, in as much as thereby it is actually severed and segregated from the other property. This seems quite clear by noting the manner in which the authorities have employed the expressions and applied the pertinent principles in the adjudicated cases. The doctrine is that, by the mere declaration, the dividend becomes immediately thereby separated and segregated from the stock and exists independently of it; that
the right thereto becomes at once immediately fixed and absolute in the stockholder, and from thenceforth the right of each individual stockholder is changed by the act of declaration from that of partner and part owner of the corporate property to a status absolutely adverse to every other stockholder and to the corporation itself, in so far as his proportion to the dividend is concerned. (Citations.)

"It follows, of course, that a cash dividend, properly and fairly declared, cannot be revoked by the subsequent action of the corporation, for it, by the declaration of the dividend, the corporation thereby becomes the debtor of the stockholder, it goes without saying that the debtor cannot revoke, recall, or rescind the debt or otherwise absolve itself from its payment by any action on its part against or without the consent of the creditor, and therefore the resolution of May 11th, attempting to do so, was of no force. (Citations.) Nor can a corporation for the obvious and confessed purpose of defrauding its payment by circumvention, defraud it by making an assessment on the stock payable on the same day as was the previously declared dividend. (Citation.)

"It is said, however, that the reasons which preclude a corporation from rescinding a cash dividend after its having been declared do not obtain in a case of a stock dividend, presumably upon the principle that in as much as the act of declaring the cash dividend not only creates a debt but therupon severs the amount thereof from the mass of the corporate funds, and property, and cannot be recalled for the reason the debtor cannot cancel a debt; and re-establish or re-establish the fruit on the tree, so figuratively referred to in the case supra; whereas the act of declaring a stock dividend does not, of itself, operate to sever the stock to be thereafter issued from the other corporate property, inasmuch as there is no stock to be severed and as the new stock cannot be issued until certain precedent conditions and formalities are complied with, such as issuing stock, the filing of certificates with the proper authorities, etc."—Norton, J.

611. Richter & Co. v. Light. — "To determine whether and when a dividend shall be declared rests within their (the directors) discretion; and, if declared, they have the power to fix the amount, time, place, manner and mode of payment, whether it shall be in stock, cash, or property, with only such limitations as reason and good faith with the stockholders may require. (Cases cited.)

"As they may determine and declare the amount of the dividend and its conditions and terms, they may prescribe the day when the division shall be made and take effect, and specify that it shall be paid to stockholders of record on its books on that day.

"It has been the general rule that the persons who are stockholders of a corporation at the time a dividend is declared are entitled to share in the dividend, regardless of the time when they acquired their stock or when the dividends were earned, and although the dividends are payable at a future date. But careful examination discloses that this rule has not been applied in any case in which the record shows that the directors' resolution in its terms declared that the dividend should be made to stockholders of record on a future day."—Burpee, J.

612. Spear v. Rockland-Rockport Lime Co. et al. — "As a general rule, the officers of a corporation are the sole judges as to the propriety of declaring dividends, and the courts will not interfere with the proper exercises of that discretion; yet, when the right to a dividend is clear, and there are funds from which it can properly be made, a court of equity will interfere to compel the company to declare it. Directors are not allowed to use their power illegally, wantonly, or oppressively. (Cases cited.)
The rights of a preferred stockholder are enforceable in equity against the company in accordance with the terms of his contract. (Citation.) And all unfair discrimination between preferred stockholders and common stockholders will be prevented.

"But even as to a preferred stockholder, unless his contract otherwise provided or requires, the profits or not earnings may be allowed to accumulate, and remain invested in the business. The officers of a corporation are invested with a discretionary power with regard to the time and manner of distributing its profits. They may use the profits for the development of the company's business so long as they do not abuse their discretionary power, or violate the charter, or the contracts made, as to profits, with particular classes of stockholders. (Citation.)

"The preferential rights of a preferred stockholder arise from his contract, which in this case is found in his stock certificate. His contractual rights the court may enforce against the corporation and other classes of stockholder. He can require the payment of dividends, when others cannot, only in case and to the extent that dividends were promised or guaranteed in his contract. Such dividends he may require whenever the company has acquired funds which may rightfully be used for the payment of dividends. (Cases cited.)

"Moreover, a preferred stockholder is not a creditor. He is a stockholder, although his peculiar rights arise from contract. He is a stockholder as to other creditors, and his rights are subordinate to theirs. He cannot claim dividends out of funds that are needed for, or that properly should be applied to, the payment of debt. (Cases cited.) He is entitled to a dividend out of not earnings only."—Savage, C.J.

813. State v. Pacific Brewing & Malting Co.—"On August 10, 1898, the respondent applied to the court for a writ of mandamus to compel the appellants to permit her to inspect the account books of the corporation. As a cause for the issuance of the writ, she alleged: 'That relator as such stockholder has for some time been desirous of learning the true condition of the affairs of said company and of the management of its business and of the value and nature of relator's interest and property therein as such stockholder, and of the manner and skill and fidelity with which relator's interests as stockholder as aforesaid are and have been attended to and protected, and to that end has sought to inspect and examine, at proper and convenient times and without interruption or embarrassment to said company, or to the management, or transaction of the business thereof, the books of account of said corporation, and has requested and demanded of said respondents permission, access and opportunity.'

"From a judgment in her favor, this appeal is taken.

"The question arises whether or not the respondent has shown facts sufficient to authorize the court to direct a writ of mandamus issue. The stockholders of a corporation have at common law, for a proper purpose and at seasonable times, a right to inspect any or all books and records of the corporation. While this right is universally recognized, the courts disagree as to what is a proper purpose, or, rather, as to what facts are sufficient to warrant the court in directing by mandamus permission to inspect, where the stockholder has been refused such by the officers of the corporation. In the early case of Rex v. Master and Wardens of the Merchant Tailors' Company, 2 Barn. & Adol. 115, it was held that before the writ could issue some distinct cause or purpose affecting the applicant personally must be shown, and a desire to examine the books for the purpose of ascertaining whether the company's affairs were being properly managed was
not sufficient cause.

"The principle announced in this case has been followed by some of the courts of this country, in so far, at least, as to hold that the mere benefit of knowledge to be derived from the books as to the proper conduct of the business is not a sufficient cause for the issuance of the writ to compel the corporate officer to grant an inspection, but that something more must be shown; as that a controversy is depending, or that some question or interest is involved with reference to which the contents of the books may be applicable.

"The injustice of the rule, when applied in all its strictness, has been so keenly felt that in England, and in many of the United States, the right of inspection of corporate books is now guaranteed to the stockholders by statute, and such statutes seem to be generally held not to be innovations in, but declaratory of, the common law. The tendency of the modern decisions, also, is towards holding that a stockholder, as such, has a right to inspect the books and other documents of the corporation, where his sole object is to inform himself as to the manner in which the business of the corporation is being conducted.

"In Huyler v. Cragin Cattle Co., 40 N. J. Eq. 392, 2 Atl. 274, it is said: 'Stockholders are entitled to inspect the books of the company for proper purposes at proper times. . . . And they are entitled to such inspection, though their only object is to ascertain whether their affairs have been properly conducted by the directors or managers. Such a right is necessary to their protection. To say that they have the right, but that it can be enforced only when they have ascertained, in some way without the books, that their affairs have been mismanaged, or that their interests are in danger, is practically to deny the right in the majority of cases. Often-times frauds are discoverable only by examination of the books by an expert accountant. The books are not the private property of the directors or managers, but are the records of their transactions as trustees for the stockholders.'

"Corporations, owing to the ease with which they can be formed under the liberal provisions of the statute, and affording as they do a limited liability for investors, have become a favorite means for the combination of capital, and are now engaged in almost every variety and character of business. In fact, they have largely superseded partnerships. Not having behind them the personal responsibility and fortunes of the promoters, or that of those who may have invested in their capital stock, the interests of the public at large require, and especially that part of the public dealing with them, that the courts adopt the rule which will most largely conduce to honesty in their management. We believe that these interests will be better protected by holding that a stockholder of a corporation has a right, at reasonable times, to inspect and examine the books and records of such corporation, so long as his purpose is to inform himself as to the manner and fidelity with which the corporate affairs are being conducted and his examination is made in the interests of the corporation. Nor will it be presumed, when such request is made, that the purpose of the inspection is other than in the interest of the corporation; and, when it is charged otherwise, the burden should be on the officers refusing such request, or the corporation, to establish it. The argument that, under this rule, the managers of a rival concern may acquire stock in the corporation and use the privilege for the purpose of benefiting the rival concern, to the detriment of the corporation, is not more forceful than the other, that, under the restricted rule, a combination can be made by persons holding the majority of the stock, by which the corporation is managed, for their own interest, to the exclusion and detriment of the minority holders and injury to the public dealing with it.

"The judgment is affirmed." -- Fullerton, J.
914. Answers to A.I.A. Questions

{(November 1918)---The power to have perpetual succession, the power to sue and be sued, the power to purchase and hold lands for authorized corporate purposes, the power to do all acts that may be necessary to enable them to exercise the powers expressly conferred and to accomplish the objects for which they were created, and the power to have a corporate seal." (b) Agreements with Promoters: "(May 1921) The general rule is that a corporation, on coming into existence, is not liable for agreements made by its promoters prior to actual incorporation. This applies to all such agreements, including those entered into by the promoters of the corporation 'connected with its incorporation,' which cover such items as lawyers' fees, state fees, recording fees and similar organization expenses. In some states it is expressly provided in the statutes that the corporation shall be liable for all expenses incurred in its organization. The reason for the general rule above states is that a corporation, not yet being in existence, cannot possibly be a party to a contract. It can, however, on coming into being, expressly or impliedly adopt precorporate contracts made by its promoters and hence become liable for the contract price or fair price, as the case may be." (c) Partnership: "(May 1923)---The general rule is that a corporation has no power to form a partnership in the absence of statutory authority, which rarely exists. Were the rule otherwise, parties outside the corporation would have the power of management and control over the corporation; also it might have burdensome responsibilities imposed upon it by non-corporate agents. Further, the road would be opened to the formation of trusts and monopolies and the performance of acts not authorized by the charter. Whether, in this case, it be the officers or the corporation itself which is to enter into partnership with W, the result is the same. The corporation is to furnish part of the capital and perform certain acts. This is clearly ultra vires. The agreement is invalid." (d) Powers of President: "(November 1917)---The president and secretary merely by virtue of their office have no power to execute a mortgage on the corporation property. In order to give a valid mortgage they must be especially authorized so to do by the board of directors, hence the holder of this mortgage could not foreclose, unless there were circumstances which would stop the corporation from showing the lack of authority. The main reason for such a rule being that the power to mortgage is the power to destroy and the management and success of the business being in the hands of the directors, anything which is fundamental to its existence must have their approval." (e) By-laws: "(June 1917)---The body who has the power by virtue of the articles of incorporation to make the by-laws, are, in the absence of a provision to the contrary, the only body who can alter the by-laws and in this case the stockholders being the body who enacted the by-laws are the only body who can alter or amend them unless there was a special authorization in the corporate articles to the contrary." (f) Director's Powers: "(June 1917)---The general rule seems to be that the directors can delegate to an executive committee any ministerial duties which they have to perform, but they can not delegate their discretionary powers and duties. The reason being, they have been chosen to manage the affairs of the corporation. Because of their skill or adaptability and they can not delegate the performance of these duties to another unless they are expressly authorized to do so by the stockholders." (g) Proxies: "(May 1923)---F could not attend and

1 Collins, p. 924
act at the meeting for he was only a proxy. A director must attend the meetings of the board and act in person. The obvious reason for this is that he is obligated to use his individual judgment with respect to matters coming up before the meeting of the board in order to further the interests of the corporation. Such individual judgment can not be exercised by a proxy.  

(b) Salaries: "(June 1917)--The directors do not have the right to vote an increase in salary for services performed in the past, the reason being that if such a practice be permitted, the stockholders and creditors would have no protection against the fraudulent combination of officers, nor would it ever be possible to determine the value of stock or the assets of the company."  

(i) Contracts: "(May 1921)--Brown, being a director, occupied a fiduciary relation to the X Company. It was therefore his duty to see that the contract with the Y Company was secured at the lowest possible price. Obviously if the Y Company could afford to give Brown $500 it could have made the price $500 less to the X Company. It was Brown's duty to see that this was done. Furthermore, because of the gift, Brown may have passed up a contract more favorable to his company from some other concern which was unwilling to make such a gift to Brown. Even, however, if the contract with the Y Company was the most favorable that could be secured, Brown still was guilty of a breach of faith. He must therefore account to his company for the $500 and surrender this sum to it. It is firmly established that in accepting secret gifts from one who is dealing with his corporation, a director commits a breach of trust and may be forced to turn over to the corporation all monies so received."  

(j) Directors' Powers: "(November 1917)--A board of directors is the governing body of the corporation and as such they are the managers of the ordinary corporate affairs, subject however to any rules and limitations prescribed by the by-laws. They have the full management of the corporate property, the distribution of its assets, the power to bind the corporation in its dealings with third persons. As to the duties in any particular line of business or particular corporation, they are necessarily dependent upon the nature of the business and the particular by-laws under which they work.  

(1) Directors are liable for losses occasioned by their wilful and intentional departure from duty, fraudulent breaches of trust, acts of gross negligence, ultra vires acts, but generally they are not held liable for mistakes of judgment.  

(2) An act would be ultra vires on the part of the corporation which would transcend the power conferred upon the corporation by law. Ultra vires when applied to corporate acts has a joint meaning. Primarily it means the performance of an act which is not within the scope of power of the corporation to perform under any circumstances or for any purpose.  

"Used in a secondary sense, it is applicable to the members of the corporation such as something beyond the power of the corporation to bind dissenting stockholders or something beyond the authority of corporate agents or officers."  

(k) Fully Paid Stock: "(November 1921) The general rule is that stockholders who have paid less than par for their stock are personally liable to corporate creditors on the insolvency of the corporation. Some states have adopted what is called the 'good faith rule.' That is, where directors have in good faith placed a certain value on property or services tendered in payment of stock, creditors cannot afterwards complain even though it should have turned out that the property or services were overvalued. The 'true value rule' is that the property or services must equal in value the par value of the stock issued. If not, creditors can sue for the difference between the cash value of the property or services and the par value of the stock."
Answering this question generally, and subject to above answer, the issue of this stock by the corporation was proper, but a liability was incurred by the holder to corporate creditors for the difference between the value of his services and the par value of the stock issued therefore.

"(May 1923)--Where dividends, ordinary or in liquidation are improperly paid to stockholders, as in this case, the stockholders may be forced to return them for the benefit of the corporate creditors. The trustee in bankruptcy succeeds to the rights of the creditors of the bankrupt and could recover on this ground. Further, stockholders are not creditors of a corporation, so that even if they took the dividends in good faith, which is evidently not the case here, the trustee could recover them on the ground that their payment constituted a fraudulent conveyance. Where a corporation wishes to dissolve, the corporation acts invariably require, among other things, that the corporation shall collect all its corporate property and discharge all its corporate debts and liabilities."

"(November 1923)--Creditors of a corporation are entitled to assume that the capital stock has been paid for in full by the subscribers thereto. Where stock subscriptions are not paid in full, it is considered to be a species of fraud on the corporate creditors. Hence A and B can be held by the creditors for such amount of the unpaid balance of their subscriptions as may be necessary to satisfy their claims. Before holding stockholders on their unpaid subscriptions, corporate creditors are usually required to reduce their claims against the insolvent corporation to a judgment, so as to remove any doubt as to the validity of their claims. In other words, they sue the stockholders in the capacity of judgment creditors of the corporation."

"(May 1918)--The general rule is that an agreement between the corporation and the stockholders that all shares shall be deemed as having been fully paid, is of no effect against the creditors of the corporation unless the shares have actually been paid for in full, the reason being, that the only way which a creditor can determine the financial status of a corporation is by its representations and assertions that he has a right to rely upon them and if they are not correct or are collusive, he has a right to come on the stockholders for the difference between the full value and the price paid and the agreement between the corporation and the stockholder cannot be interposed as a defense.

"(1) Treasury Stock: "(May 1918) In general, in the absence of constitutional, statutory or charter restrictions, a corporation may purchase and hold shares of its own stock provided such purchase is in good faith and fairly made, and the corporation is solvent and that the rights of creditors and non-assenting stockholders are not prejudiced thereby.""(November 1924)--In the absence of constitutional, statutory or charter restriction, by the weight of authority in the United States a corporation may purchase and hold shares of its own stock provided that the corporation in making such purchase is acting in good faith and that the consideration paid is not unequal or disproportionate to the value of the stock, that the corporation is solvent and not contemplating or in process of dissolution, and that the rights of creditors and non-assenting stockholders are not adversely affected. To be valid against non-assenting parties the purchase must be by authority of the directors, although officers of the corporation may purchase without that authority so far as consenting parties are concerned."

"(November 1917) Cumulative voting is a system by which the stockholders having a number of votes equal to the number of officers to be chosen are permitted to concentrate their whole number of votes on one person or to distribute them as they see fit. For example, if there are ten directors to be elected, the stockholders being entitled to one vote for each, can give all ten votes to one director if they see fit. This right did not exist at common law, but exists only by provision of statute, the purpose of it being to permit
minority stockholders to place some directors on the board of their own selection. The right is used most frequently when the majority stockholders attempt to prevent the minority stockholders from being represented on the board of directors."

**REVIEW QUESTIONS**

1. State 3 rules of law based on Chicago Title and Trust Co. v. Munday.
2. What is the law in respect to agreements made with promoters prior to incorporation?
3. Summarize briefly the points of law, including their solution, which arose in Minnesota Loan & Trust Co. v. Peteler Car Co.
4. State 5 rules of law taken from the Ohio Corporation Law.
5. What are a director's right to inspect corporate records?
6. What are a stockholder's chief individual rights?
7. State 6 rules of law developed in Continental Securities Co. v. Belmont.
8. What are the chief liabilities of a stockholder?
9. What are the powers of a corporation?
10. What rules of law are developed in Richter & Co. v. Light?
11. Who can alter the by-laws?
12. What is the law in respect to fully paid stock?
13. What powers can the directors delegate?
14. Who are de facto directors? When are their acts valid?
15. State 3 rules of law developed in Cheeney v. Lafayette, B & M R Co.
16. What rules of law are developed in Spear v. Rockland-Rockport Line Co. et al?
17. Comment upon the right of a corporation to purchase its own stock.
18. Restate in your own words the substance of State v. Pacific Brewing & Malting Co.
20. What are the powers of the officers of a corporation?
22. What are a stockholder's chief rights in a collective capacity?
23. Is the separate action of individual directors the equivalent of their action as a board?
815. Introductory Comment.--This chapter will be devoted to a
reiteration of certain observations made previously herein on this topic,
together with a further expansion thereof.

816. The All-Purpose Balance Sheet.--It is admitted in practically
all accounting circles that an all-purpose balance sheet is impossible.
For example, a balance sheet drawn up on a business preparatory to its
liquidation must be radically different in form, contents, valuation and
presentation from the balance sheet of a going concern preparatory to its
seeking a line of bank credit.

While it is true that most balance sheets are prepared for persons
who are not primarily interested in the current position of the company,
nevertheless, it is practical and expedient for the auditor to assume that
the balance sheet will eventually be submitted to a current creditor (or
prospective creditor), seeing that the client will not undertake to have
the auditor prepare a second one especially for this purpose.

817. Client v. Auditor.--The reader must realize that very often
the form of the balance sheet is dictated by the client. Thus, for example,
if the client desires to show the treasury stock as an asset, instead of as
a subtraction from the capital stock outstanding, the auditor will not object
to it as long as it is labelled Treasury Stock and NOT Investments. By
acceding to the wishes of his client, the auditor fulfills his obligation
to him, and at the same time the auditor fulfills his duty to the public by
captioning the item as Treasury Stock instead of Investments. If the auditor
permitted the latter caption, he would be guilty of sanctioning a deception.

The same sort of situation arises whenever a client desires the
auditor to place the capital stock first and the surplus last, or even to
follow the English custom of placing the equities on the left-hand and the
assets on the right-hand side of the exhibit. In short, one must never
1. The number of shares must always be stated.
2. See the ADDENDUM.
3. Some clients, for example, prefer the title LIABILITIES to LIABILITIES and
   CAPITAL for the caption of the equity side of the balance sheet.
assume that the auditors do not know the essentials of correct balance sheet or other presentation just because there appears in a report an exhibit on which the reader could improve.

However, where the client is obviously ignorant of what constitutes a correct presentation, the auditor should tactfully show and convince the client that its poor and illogical balance sheet presentation will reflect upon the management and the accounting department of the company. Those who know, for example, that treasury stock is not an asset will ascribe the error either to ignorance or to "window dressing." In either case, the observation is derogatory to the best interests of the company.

818. Condensed Balance Sheets.—While condensed balance sheets are a necessity in many types of published statements, nevertheless, as a general rule it is true that the condensation is usually so great as to negative the usefulness of the exhibit. Furthermore, the condensation should not be used as a cloak for concealing items that should be disclosed.

819. Descriptive Balance Sheets.—In some organisations, particularly banks, the balance sheet presentation for circulation among the general public has assumed a radically new form from the conventional arrangement. This innovation has been favorably commented on, and rightly so, by the Journal of Accountancy as follows:

"There have been experiments lately of a new form of financial statement. Take, for example, the narrative scheme which has been adopted by the Corn Exchange Bank of New York in its statement of condition. In many theatres while one awaits the ascent of the curtain he can while away his time learning from the programme something about the activities and accomplishments of this large local bank. If he knows nothing whatever about the theory of debit and credit and is profoundly innocent of all acquaintance with the complexities of double-entry, he can read the report of this bank without any great mental strain, and when he has reached the end he really knows quite a good deal about the condition in which the bank is said to be. He is not responsible for the accuracy of the figures, but that, on the other hand, is a matter with which he will not concern himself. The ordinary reader must depend upon the integrity of those who make financial statements. It will be sufficient for him if he may understand what the statements are trying to tell him. This question of making accounts intelligible is frequently discussed by accountants at their meetings and it is unusual to find anyone who is logically opposed to the adoption of a reform. The obstacle seems to be inertia. What has been done for many years is easier to follow than some new plan which has been tried only by a few pioneers."

"Let us suppose, for purposes of argument, that some great corporation whose securities are owned in every part of the country, were to issue its annual statement to stockholders in a new narrative form. What objection could be raised to such a change? The facts would be presented as they are at present in the prevailing system; there would be nothing withheld which is now available; the dignity of the accounting department would not be jeopardized, and the authority of the public accountant who certified would not diminish in any way. On the other hand, the public would come to have a greater respect for everyone concerned with the preparation and certification of the accounts if advertising were done in a clear and common-sense way. One of the objections which the public raises to the operations of the legal profession is because of the almost incomprehensible mass of verbiage which cloaks every decision or legal opinion. "Why the devil," says the man in

1. See September 1930 balance sheet of Canada Dry Ginger Ale, Inc.
2. The Journal of Accountancy, July 1930 (p. 6)
the street, "can't the lawyer say what he wants to say without mingling a lot of long words, dog Latin and idle redundance in every document?" In the same way there are physicians and surgeons, and perhaps there still are some of them, who made it a principle in their practice to impress the patient with their erudition. They attempted to mystify by words, or even more by silence, when all that was necessary was a little good advice or diet or simple remedies. Those old befuddlers--most of them, at any rate--have gone out of practice. The modern physician tells his patient what he thinks is the matter with him and if he is wise he usually adds, 'But, of course, we never can be sure. What I am giving you is my personal opinion based upon such experience as I have had.'

"The accountant seems to have felt for many years that his success depended upon adherence to a complicated system of technique in expression. We hear of funds and reserves and amortizations and obsolescences, and the God only knows what else, which are merely names to most people. That very holy formula of double-entry itself is quite beyond the comprehension of an ordinary person who does not devote his life to its consideration. Why, in the name of all that is reasonable, should we not adopt a sensible method of stating a simple fact? The purpose of a statement of accounts is said to be the information of the reader. Well, then, is it not better that effort should be made to accomplish the purpose in mind? Those few corporations which have adopted the plan of trying to speak plainly to the ordinary stockholder have been successful. There has been no protest from anyone because of the reform. Of course, for consolation or delight of the accountant it may be well to adhere to the old system of balance-sheet, income account, etc., with all the balances which are necessary to maintain apparent equilibrium, but we venture to express the opinion that the public, which is really the ultimate consumer of all professional service, would vastly prefer what has been called the narrative form of statement to anything else that has ever been devised. We are told that Pacioli, or perhaps someone even earlier than he, devised this marvelous thing known as double-entry bookkeeping. Is there any other science in which a formula devised by a pure theorist has remained unaltered during the march of progress in four hundred years? It is probably rank heresy to say this, but we admit that the form of statement presented by the Corn Exchange Bank of New York seems less distressing than the best manifestation of fifteenth-century practice. Perhaps someone will feel inclined to tell us that there is no reason to depart from precedent, but we feel rather strongly that the result of a straw vote on such a question would be a revelation to the die-hards."

On the other hand, Professor Kohler says:

"Equally worthy of condemnation is the so-called "descriptive" balance sheet, which is the soupy pulp that some of the utilities have recently been issuing to their stockholders . . . . in effect they are condensed balance sheets containing obvious remarks about obvious items and wholly insufficient remarks about much more important items difficult or impossible for the ordinary reader to comprehend."¹

Accordingly, it would seem that a good accounting tool, like a machine tool, can be totally destroyed by a poor or wilfully destructive workman. The new tool (descriptive balance sheet) itself, however, is undoubtedly an advancement in the art of making figures speak.

621. Balance Sheet Captions. — Although the caption, EQUITIES, is suitable for the major heading of the account form of balance sheet, it is somewhat too technical for general use. The use of LIABILITIES is, of course, the most common of all practices, but grossly incorrect. However, the auditor should observe that this caption may be required, as by the New York Stock Exchange rules and regulations. Next, the designation LIABILITIES, RESERVES, and CAPITAL is objected to by good authority inasmuch as the term 'reserves' is used interchangeably with surplus by many financial writers. In the writer's opinion, the caption, LIABILITIES AND CAPITAL is correct and adequate.

Under this heading, attention should be directed to the necessity for abandoning all technical words and terms. Ledger account titles which are not descriptive of the nature of the items within must be abandoned in favor of lucid descriptions however wordy.

The writer also wishes to stress again the necessity of stating the TOTAL LIABILITIES. Necessarily, the adoption of this practice will cause a breaking up of the items under the common and abominable caption, RESERVES. Offsets to assets will then be deducted from their respective assets; liabilities will be properly classified; surpluses will be assembled under networth; and true contingencies will be located between the liabilities and the capital.

622. "Current" v. "Fixed" Arrangement. — There are, of course, two main types of balance sheets — the report form and the account form — and there are also two common arrangements within each of these two types of presentations.

First, there is the "current" to "fixed" arrangement; thus,

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>Current Liabilities</td>
</tr>
<tr>
<td>Prepaid Assets</td>
<td>Deferred Income</td>
</tr>
<tr>
<td>Permanent Investments</td>
<td>Long-term Debt</td>
</tr>
<tr>
<td>Funds</td>
<td>Reserve for Contingencies</td>
</tr>
<tr>
<td>Investments in Subsidiaries</td>
<td>Capital</td>
</tr>
<tr>
<td>Plant Property</td>
<td></td>
</tr>
<tr>
<td>Intangibles</td>
<td></td>
</tr>
<tr>
<td>Deferred Charges</td>
<td></td>
</tr>
</tbody>
</table>

Second, there are two alternative presentations of "fixed" to "current" as follows: (a) the "correct" form:

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant Property</td>
<td>Long-term Debt</td>
</tr>
<tr>
<td>Investments in Subsidiaries</td>
<td>Current Liabilities</td>
</tr>
<tr>
<td>Funds</td>
<td>Deferred Income</td>
</tr>
<tr>
<td>Permanent Investments</td>
<td>Reserve for Contingencies</td>
</tr>
<tr>
<td>Current Assets</td>
<td>Capital</td>
</tr>
<tr>
<td>Prepaid Assets</td>
<td></td>
</tr>
<tr>
<td>Intangibles</td>
<td></td>
</tr>
<tr>
<td>Deferred Charges</td>
<td></td>
</tr>
</tbody>
</table>

1. I.E., OTHER ASSETS (not Prepaid Assets)
2. If it is to be earned currently, otherwise it is "fixed".
A DESCRIPTIVE BALANCE SHEET PLATE 235

THE SLATER INDUSTRIAL PLAN BANK
Ashton, Rhode Island

Statement of Condition at Close of Business, December 31, 1931.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve for Taxes, Interest, Etc.</td>
<td>$209,581.27</td>
</tr>
<tr>
<td>The Bank Owes to 31,799 Depositors</td>
<td>$11,913,220.54</td>
</tr>
<tr>
<td>(These accounts are all earning 4% interest)</td>
<td></td>
</tr>
<tr>
<td>Total of all Indebtedness</td>
<td>$12,122,801.81</td>
</tr>
</tbody>
</table>

To Meet This Indebtedness The Bank Has:

- Cash on Hand and in Banks: $1,028,207.85
  - (Gold, bank notes and specie on hand and with legal depositaries, returnable on demand)
- Cheques On Other Banks: 602,015.05
  - (Payable in one day)
- U.S. Government Securities: 550,095.87
  - (This is the safest form of investment in which we could place YOUR deposits)
- Loans to Individuals and Corporations: 10,383,205.83
  - (This sum is loaned on 15,670 accounts. It is payable when we ask for it, and is secured by collateral worth at least $18,000,000.00)
- Real Estate Mortgages: 1,402,411.12
  - (All loaned on A-1 Real Estate in Rhode Island or nearby Massachusetts and Connecticut up to not more than 60% of the value of the property)
- Bonds: 1,010,205.83
  - (Of railroads and other corporations, of first quality and listed on the principal Exchanges)
- Banking Houses and Fixtures: 638,109.10
  - (Five in number, all located in Ashton)
- Other Resources: 12,369.57
- Total Resources to Meet Above Indebtedness: 15,626,640.22
- Excess of Resources over Indebtedness: $5,703,838.41
  - (This is represented by Capital Stock, Surplus Fund, and Undivided Profits Earned belonging to 1,205 stockholders. It is a guarantee fund which will not be withdrawn by them until the depositors are paid in full.)

**820. Explanation and Comments.—**This plate illustrates a laudable attempt on the part of "The Slater Savings and Industrial Bank" to present a statement of its financial position which will be intelligible and hence of interest to its depositors.

As yet, very few manufacturing plants, retail stores, or other types of business or commercial activity, have issued descriptive balance sheets of a type calculated to arouse the interest of its smallest stockholder.

Note that the statement does not tell on what basis the securities, etc. are valued. Accordingly, in periods of depression, such as 1929-1933, the statement is meaningless. This criticism is applicable to most bank balance sheets.
and (b) the "popular" form:

**ASSETS**
- Plant Property
- Investments in Subsidiaries
- Funds
- Permanent Investments
- Current Assets
- Prepared Assets
- Intangibles
- Deferred Charges

**LIABILITIES**
- Capital Stock
- Long-term Debt
- Current Liabilities
- Deferred Income
- Reserves
- Surplus

As might be expected, each of these two types of presentations has its own function. If, for example, the balance sheet is to be submitted to a bank, the "current" to "fixed" arrangement is the more desirable one. On the other hand, if the exhibit is to be presented to an investment house which is contemplating the floating of the Company's new bond issue, the "fixed" to "current" presentation is the one desired. In most instances, therefore, the balance sheet should be drawn up on a "current" to "fixed" basis.

Attention is also directed to the poor and illogical arrangement of the balance sheet in Plate 236. Among other objections, it may be noted that the RESERVES are not all of the same type. Secondly, the total capital is split in at least two:--the capital stock being placed first, and the surpluses last. Thirdly, there is no attempt to arrive at a TOTAL LIABILITIES. And fourthly, the DEFERRED CHARGES TO OPERATIONS is partly composed of current prepaid assets.

Although these objections to this type of balance sheet are well founded, nevertheless, there is no reason why an auditor should object to drawing up a statement of this sort in compliance with the wishes of the client. In fact, this form of presentation is of long standing with some companies and well established in practice. When presented with the proper amount of detail, there is no deception involved; simply "poor taste", as it were.

As was stated at the outset of this section 692, there is the so-called "report form" of balance sheet wherein the arrangement is as follows (classifications omitted):

```
<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>$XX</td>
<td>$XX</td>
</tr>
<tr>
<td>$XX</td>
<td>$XX</td>
</tr>
<tr>
<td>$XX</td>
<td>$XX</td>
</tr>
<tr>
<td>$XX</td>
<td>$XX</td>
</tr>
</tbody>
</table>
```

1. As to the general public, this hodge-podge arrangement is truly deceptive in that it is a half-truth; i.e. all the facts are there, but it is well known by the management that the public will be unable to put the pieces of the puzzle together in their proper order.
Obviously, this type of presentation is elementary inasmuch as everyone is familiar with the basis of the presentation; namely, that ASSETS minus LIABILITIES leaves NETWORTH. It is not surprising, therefore, that many "small" clients prefer this form, as does also the general public.

Reference should also be made to the balance sheet of the Federal Reserve Board as given in Chapter 49.

823. See Plate 236.
824. See Plate 237.
825. See Plate 237.

826. The Internal Presentation.—By way of summarizing and centralizing under one head certain ideas and opinions on the internal presentation of the balance sheet as expressed hereinbefore, the following paragraphs are devoted to that purpose.

(a) Cash.—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 bankrupt or closed banks.\(^1\) Deposits made as guarantees are usually both fixed and pledged.

As a rule, it is sufficient to show the general cash in one amount; but if the sum on hand is large, it may be advisable to show it separately as Cash on Hand, and Cash in Banks.

A bank overdraft should be shown as a liability unless the other bank balances are large enough to cover it; i.e., in excess of the amount which the banks require as a non-withdrawable base deposit. Of course, if the drawn checks which cause the overdraft are on hand, these may be added back.

(b) Working Funds.—These are the funds in the possession of cashiers, branches, traveling salesmen, etc. for the payment of current expenses or other small expenditures not conveniently paid by check from the general cash.

Good practice permits these sums to be classified either under prepaid assets or as a part of the general cash, provided they have been cleared of all expense vouchers. The writer looks upon them as prepaid assets.

The various funds may be shown separately or in toto as befits the circumstances.

(c) Trade Notes and Acceptances Receivable.—It is always essential that notes be subdivided into "current" and "fixed", and into trade, affiliated interests, officers, loans, and so on.

If any notes are pledged, this fact must be separately stated and distinctly described in complete detail.

Notes which have been discounted are preferably set forth as follows:

\[
\begin{align*}
\text{Notes Receivable} & \quad \$xx \\
\text{Less} & \quad \text{Notes Receivable Discounted} \quad xx & \quad \$xx \\
\text{Less} & \quad \text{Allowance for Doubtful Debts} \quad xx & \quad xx
\end{align*}
\]

Under a second method, the notes receivable are shown gross as a current asset, whereas those under discount are shown as a current liability. A third plan is to enter "short" in the current liability section those under discount, those shown as current assets being the net amount on hand.

---

\(^1\) Perhaps not assets at all.
Finally, a footnote of this contingent liability may be made at the bottom of the balance sheet.

In classifying collateral notes as a separate item, the term Collateral Notes Receivable is sufficient to denote that they are secured. Rarely ever is the nature and amount of the collateral stated, although the comments in the report will contain the full details thereof.

Trade notes and acceptances may just as well as not be combined into a single amount, unless the acceptances are large in amount.

If any note is very large, the auditor should set it forth separately, as when one note is for $100,000 and all the others are not over $5,000 each -- the total being, say, $165,000.

(d) Accounts Receivable. As in the case of notes receivable, it is VERY important that the accounts be subdivided into "current" and "fixed", and into trade, affiliated interests, officers, loans, and so on. The amount of installment accounts should also be stated separately from the "regular accounts". Naturally, the extent to which the accounts other than with customers are itemized depends both upon the amount and on other similar conditions. Where the total of these "other accounts" is small, they may be grouped together as, Accounts Receivable -- Other.

Hypothecated accounts may be set forth thus: Trade Accounts Receivable (pledged -- contra). . . . $xx; and the liability secured therewith should also be clearly earmarked, thus: Notes Payable -- Officers (secured by trade accounts receivable -- contra). . . . $xx.

Where accounts have been sold with a guaranty, they may be shown thus:

Accounts Receivable
Less - Accounts Receivable - Sold with guaranty
$xx
xx
$xx

Or, there are the same three other optional treatments given supra for the notes receivable discounted.

If the sum of the credit balances is sizable, it must be set out separately as a current liability as Customers' Credit Balances. On the other hand, the debit balances in the accounts payable should be transferred to this division of the balance sheet as Creditors' Debit Balances. This assumes that in either case the balances arise from normal transactions. If, however, for example, a debit balance in the creditors' ledger arises from an advance payment on merchandise to be received in the near future, the amount should be shown under CURRENT ASSETS as, "Advances on Materials Contracted For" -- NOT as an account receivable. When the balances are small they may be treated as Vouchers Payable and Accounts Receivable respectively.

Any considerable amount of past due accounts (or notes) must be stated. Accrued income should be set forth separately, but may be included in the accounts receivable in a condensed statement, provided the amount is small comparatively. On some audits the accruals may be omitted, but if so, the report should state it.

As stated above, certain accounts may be "fixed" and not "current", such as, for example, an advance or trade receivable of a permanent character due from a subsidiary. Such an item should be placed under the caption, INVESTMENT IN SUBSIDIARIES.

(e) Allowance for Bad Debts. -- When the amount in the allowance represents an honest effort to evaluate BOTH the accounts and notes, it should be deducted from the asset accounts, except in published statements where the

1See Appendix C, Sec. 6-#1.
asset may be shown "net of reserves". This procedure is justifiable on the ground that the Auditors' Certificate sufficiently protects a third party as to the existence of an adequate allowance, and on the ground that the amount of allowance reveals information that is essentially private.

If desired, the amount of the allowance for anticipated sales discounts, if any, may be combined with the allowance for bad debts in the balance sheet presentation, but separate accounts should be maintained in the ledger.

There seems to be no good reason for carrying these allowances as surplus, unless they are largely in excess of a reasonable amount. Even then a part of the allowance is a true asset-offset.

(f) Inventories.--The standard (and satisfactory) classification of inventories on the balance sheet is finished goods, work-in-progress, raw materials, and supplies. As to supplies, these are sometimes but not preferably combined with raw materials. Also, supplies are often 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 do not enter directly into the finished product in the same way that raw material does, but they do enter the final cost of the finished good as a part of the factory overhead. Stationery and Office Supplies are Prepaid Assets.

In a consolidated balance sheet the inventories may be lined up, if necessary, somewhat as follows: assuming, for example, that Co. A's finished product is Co. B's sole raw material:

<table>
<thead>
<tr>
<th>INVENTORIES (At &quot;Cost or Market&quot;)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw materials</td>
<td>Co. A</td>
</tr>
<tr>
<td>Goods-in-Process</td>
<td></td>
</tr>
<tr>
<td>Goods-in-Process</td>
<td>Co. A</td>
</tr>
<tr>
<td>Finished Goods</td>
<td>Co. A</td>
</tr>
<tr>
<td>Raw Material</td>
<td>Co. B</td>
</tr>
<tr>
<td>Goods-in-Process</td>
<td>Co. B</td>
</tr>
<tr>
<td>Finished Goods</td>
<td>Co. B</td>
</tr>
<tr>
<td></td>
<td>Total</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Repair Orders in process must NOT be treated as Goods-in-Process. They should either be expensed or capitalized as required by the facts. Likewise, machinery withdrawn from the factory, because there is no demand for its product, or extra machinery or motors, etc. held in reserve for breakdowns, should be weeded out of inventories and placed among the plant properties under special captions. Finally, maintenance items such as window frames, doors, etc., must be classified as plant property if, for example, they were purchased (or are to be used) to complete an addition to a building.

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.

In some situations the unit price of the raw material should be noted parenthetically, thus:

Raw Cotton (full description of the cotton) at \( \frac{\$}{\text{lb}} \) ... \( \frac{\text{xxx}}{\text{lb}} \)

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" in the inventory section. In specific cases this information is actually necessary for informative purposes, because the very small amount of inventory which appears on the balance sheets of these businesses would
### CURRENT ASSETS:

**Cash:**
- Cash in Current Bank Accounts and on Hand
- Cash on Deposit to Pay Interest Coupons and Dividends
- Cash in Sinking Funds (not in Hands of a Trustee)

**Trade Receivables:**
- Notes and Acceptances (Past due)
- Accounts (Past due)

**Less-Allowances**

**Inventories (At the lower of Cost or Market):**
- Finished Goods on Hand
- Finished Goods on Consignment
- Goods-in-Process
- Raw Materials
- Supplies

**#Temporary Investments (At Market Value):**

**Due from Subscribers to Capital Stock:**

**#Accrued Receivables:**

**#Prepaid Assets:**

### PERMANENT INVESTMENTS:

**#Securities (Market Value):**

**#Real Estate**

### BOND SINKING FUND:

**#Cash and Securities with Trustee**

**#Other Investments**

### INVESTMENTS IN SUBSIDIARIES:

**#Securities (At Adjusted Cost)**

**Loans**

### PLANT PROPERTY:

<table>
<thead>
<tr>
<th>Gross</th>
<th>Reserve</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>xx</td>
<td></td>
</tr>
<tr>
<td>Waterways</td>
<td>xx</td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Machinery</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Tools and Fixtures</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Patterns and Dies</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Dams</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Furniture and Fixtures</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Autos and Trucks</td>
<td>xx</td>
<td>xx</td>
</tr>
</tbody>
</table>

**Total**

### INTANGIBLES:

**Goodwill and Trademarks**

**Patents**

**Charters and Franchises**

### DEFERRED CHARGES:

**Bond Discount and flotation Expense**

**Organization Expense**

**TOTAL ASSETS**

# Give full descriptive details in most instances, or sub-schedules.
CURRENT LIABILITIES:

- Short Term Notes - due March 15, 19--
- Notes Payable - Banks
- Notes Payable - Brokers
- Notes Payable - Other
- Trade Acceptances
- Notes Payable - Trade
- Accounts Payable - Trade
- Accounts Payable - Other
- Accrued Payables:
  - Common Stock - 10% - due Jan. 15, 19--
  - Preferred " - 7% - " "
- Deferred Payables:
  - Dividends Payable:

DEFERRED INCOME (SERVICE CONTRACTS OUTSTANDING)

LONG TERM DEBT:

- Long Term Notes - 5% - Due 1936
- Convertible Sinking Fund 6% Gold Bonds - due 1940:
  - Total Issued
  - Retired Through Sinking Fund
  - TOTAL LIABILITIES

RESERVE FOR CONTINGENCIES

CAPITAL:

- Capital Stock:
  - Common Stock-Par $.50 (Auth. 10,000 Sh; in Treas. $.50 Sh)
  - Preferred Stock-(7½ Cumulative,Par $.10;Auth.$10,000 sh)
- Surplus (Exhibit B):
  - Earned Surplus
  - Appropriated Reserves
  - Capital Surplus
  - TOTAL LIABILITIES AND CAPITAL

623. Explanation and Comments:—This type of arrangement, i.e.,
"Current to fixed" should be used wherever possible; it is not a model.
It is to be understood that the item of "Cash in Sinking Funds
not in Hands of a Trustee" is available for current purposes.

As indicated by the mark (#), there are many occasions on which the
details of certain of the captions would be presented on the balance sheet
itself.

Notice the sharp distinction made between "Prepaid Assets" and
"Deferred Charges".
Observe also that it is sometimes advisable to show separately the
goods out on consignment.

In the "LIABILITY" section of the exhibit, the auditor has arrived
at a "TOTAL LIABILITIES".

In this case the "RESERVE FOR CONTINGENCIES" is a true contingency
reserve; i.e., it is neither a valuation reserve, nor a liability, nor a
surplus.

Finally, note that: (1) treasury stock is treated as a deduction
from capital stock outstanding; and (2) Surplus is amplified in Exhibit B.
## Assets

<table>
<thead>
<tr>
<th>PLANT PROPERTY:</th>
<th>Gross</th>
<th>Reserve</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>xx</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td>Waterways</td>
<td>xx</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td>Buildings</td>
<td>xx</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td>Machinery</td>
<td>xx</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td>Tools and Fixtures</td>
<td>xx</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td>Patterns and Dies</td>
<td>xx</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td>Dams</td>
<td>xx</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td>Furniture and Fixtures</td>
<td>xx</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td>Autos and Trucks</td>
<td>xx</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>xx</strong></td>
<td><strong>xx</strong></td>
<td><strong>xx</strong></td>
</tr>
</tbody>
</table>

## Investments in Subsidiaries:

<table>
<thead>
<tr>
<th>#Securities</th>
<th></th>
<th></th>
<th>xx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advances</td>
<td></td>
<td></td>
<td>xx</td>
</tr>
</tbody>
</table>

## Intangibles:

| Goodwill and Trademarks |     |     | xx |
| Patents                |     |     | xx |
| Charters and Franchises |     |     | xx |

## Permanent Investments:

| #Securities |     |     | xx |
| #Real Estate |     |     | xx |

## Current Assets:

| Cash:                                   |     |     | xx |
| Cash on Hand and in Banks               |     |     | xx |
| Cash on Deposit for Current Purposes    |     |     | xx |
| Trade Receivables:                      |     |     | xx |
| Notes                                   |     |     | xx |
| Acceptances                             |     |     | xx |
| Accounts                                |     |     | xx |
| **Total**                               | **xx**|     | xx |
| Less - Allowances                       |     |     | xx |

## Inventories:

| Finished Goods on Hand |     |     | xx |
| Finished Goods on Consignment |     |     | xx |
| Goods-in-Process       |     |     | xx |
| Raw Materials          |     |     | xx |
| Supplies               |     |     | xx |

## Temporary Investments:

| Due from Subscribers to Capital Stock |     |     | xx |

## Accrued Receivables:

| xx |     |     | xx |

## Prepaid Assets:

| xx |     |     | xx |

## Deferred Charges:

| Unamortized Bond Discount and Expense |     |     | xx |
| Organization Expense                 |     |     | xx |

## TOTAL ASSETS

|     |     | xx |

# Give full descriptive details in most instances, or sub-schedules.
## LIABILITIES AND CAPITAL

### LONG TERM DEBT:
- **Long Term Notes - 5 1/2% - Due 1936**
- **Convertible Sinking Fund 6% Gold Bonds - due 1940:**
  - Total Issued
  - Retired through Sinking Fund
  - Less - Bond Sinking Fund

### CURRENT LIABILITIES:
- **Short Term Notes - due April 15**
- **Notes Payable - Banks**
- **Notes Payable - Brokers**
- **Notes Payable - Other**
- **Trade Acceptances**
- **Notes Payable - Trade**
- **Accounts Payable - Trade**
- **Accounts Payable - Other**
- **Accrued Payables:**
  - **Dividends Payable:**
    - Common Stock - 10% - due Jan. 15
    - Preferred Stock - 7% -

### DEFERRED INCOME
- **TOTAL LIABILITIES**

### RESERVE FOR CONTINGENCIES

### CAPITAL:
- **Common Stock** - (5000 shares, no-par-value; Auth. 15000 shares)
- **Preferred stock** - (7% Non Cumulative-Par $100; Auth. 10,000 shares)

### Surplus (Exhibit B):
- **Earned Surplus**
- **Appropriated Reserves**
- **Capital Surplus**

### TOTAL LIABILITIES AND CAPITAL

824. Explanation and Comments.--When the balance sheet arrangement is from "fixed to current", the "preferred" form is to keep the liabilities together, and the capital items together.

Notice the detail in which the long term debts, the dividends payable, and the capital stocks are given.

Here again it must be understood that the "RESERVE FOR CONTINGENCIES" is a true contingency reserve. If it were an offset to some asset, it would have been deducted on the asset-side; if it were a liability, it would have been placed in that class; or if the contingency were a very remote one, the reserve would have been treated as an item of appropriated surplus.

Notice that the Allowance for Doubtful Accounts is made to apply both to the notes and to the accounts receivable.
## ASSETS

### PROPERTY AND PLANT:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate and Buildings</td>
<td>xx</td>
</tr>
<tr>
<td>Machinery, Tools and Fixtures</td>
<td>xx</td>
</tr>
<tr>
<td>Patterns and Dies</td>
<td>xx</td>
</tr>
<tr>
<td>Mines, Lumber Tracts, and Other Properties (utilized in connection with the regular operations of the business)</td>
<td>xx</td>
</tr>
<tr>
<td>Office Furniture</td>
<td>xx</td>
</tr>
<tr>
<td>Horses, Wagons, and Automobiles</td>
<td>xx</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>xx</td>
</tr>
<tr>
<td><strong>Less - Reserve for Depreciation</strong></td>
<td>xx</td>
</tr>
<tr>
<td><strong>Total Property and Plant</strong></td>
<td>xx</td>
</tr>
</tbody>
</table>

### GOOD-WILL, PATENTS, CHARTERS, AND FRANCHISES:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Give details)</td>
<td>xx</td>
</tr>
<tr>
<td><strong>Total Good-will, Patents, Charters &amp; Franchises</strong></td>
<td>xx</td>
</tr>
</tbody>
</table>

### SINKING FUND:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and Securities in hands of Trustee for Redemption of Funded Debt</td>
<td>xx</td>
</tr>
<tr>
<td>Other Sinking Fund Investments</td>
<td>xx</td>
</tr>
<tr>
<td><strong>Total Sinking Fund</strong></td>
<td>xx</td>
</tr>
</tbody>
</table>

### COMPANY'S SECURITIES IN TREASURY:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks and Bonds of Affiliated Companies</td>
<td>xx</td>
</tr>
<tr>
<td>Other Stocks and Bonds</td>
<td>xx</td>
</tr>
<tr>
<td><strong>Total Securities Owned</strong></td>
<td>xx</td>
</tr>
<tr>
<td><strong>Less Reserve for Adjustment of Values</strong></td>
<td>xx</td>
</tr>
<tr>
<td>Income Producing Real Estate</td>
<td>xx</td>
</tr>
<tr>
<td><strong>Less - Reserve for Depreciation</strong></td>
<td>xx</td>
</tr>
<tr>
<td>Vacant Land Held as Investment</td>
<td>xx</td>
</tr>
<tr>
<td><strong>Total Investments</strong></td>
<td>xx</td>
</tr>
</tbody>
</table>

### CURRENT ASSETS:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash in current bank accounts and on hand</td>
<td>xx</td>
</tr>
<tr>
<td>Cash on deposit to pay interest coupons and dividends</td>
<td>xx</td>
</tr>
<tr>
<td>Cash sinking funds not in hands of a Trustee</td>
<td>xx</td>
</tr>
<tr>
<td>Notes Receivable</td>
<td>xx</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>xx</td>
</tr>
<tr>
<td><strong>Total Notes and Accounts Receivable</strong></td>
<td>xx</td>
</tr>
<tr>
<td><strong>Less - Reserve for Doubtful Notes &amp; Accounts Receivable</strong></td>
<td>xx</td>
</tr>
<tr>
<td>Trade Acceptances Receivable</td>
<td>xx</td>
</tr>
<tr>
<td>Dues from subscribers to capital stock</td>
<td>xx</td>
</tr>
<tr>
<td>Items accrued but not yet due (show details)</td>
<td>xx</td>
</tr>
<tr>
<td>Inventories:</td>
<td>xx</td>
</tr>
<tr>
<td>Raw Materials and Supplies</td>
<td>xx</td>
</tr>
<tr>
<td>Goods in process</td>
<td>xx</td>
</tr>
<tr>
<td>Finished goods on hand</td>
<td>xx</td>
</tr>
<tr>
<td>Finished goods on consignment</td>
<td>xx</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td>xx</td>
</tr>
</tbody>
</table>

### DEFERRED CHARGES TO OPERATIONS:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance premiums unexpired</td>
<td>xx</td>
</tr>
<tr>
<td>Prepaid taxes</td>
<td>xx</td>
</tr>
<tr>
<td>Prepaid Interest</td>
<td>xx</td>
</tr>
<tr>
<td>Prepaid advertising</td>
<td>xx</td>
</tr>
<tr>
<td>Bond discount and expenses unextinguished</td>
<td>xx</td>
</tr>
<tr>
<td><strong>Total Deferred Charges to Operations</strong></td>
<td>xx</td>
</tr>
</tbody>
</table>
RIGHT SIDE OF PLATE 238

LIABILITIES

PREFERRED CAPITAL STOCK ........................................... SHARES OF £100 EACH xx
COMMON CAPITAL STOCK ............................................... SHARES OF £100 EACH xx

FUNDED DEBT:
Convertible Sinking Fund 6% Gold Bonds, Due (date):
   Total Issued ....................................................... xx
   Retired Through Sinking Fund ................................. xx
   Balance Outstanding ............................................. xx
Fonds Assumed:
   (Give Details) .................................................... xx xx
Long Term Notes:
   (Give Details) .................................................... xx xx

Total Funded Debt .................................................... xx

PURCHASE MONEY MORTGAGES AND CONTRACTS:
   (Give Necessary Details) ........................................ xx

Total Purchase Money Mortgages and Contracts ............... xx

CURRENT LIABILITIES:
   Notes Payable - Bank ........................................... xx
   Notes Payable - Trade ........................................... xx
   Notes Payable - Officers ....................................... xx
   Trade Acceptances Payable ................................... xx
   Accounts Payable ................................................ xx
   Items Accrued But Not Due:
   Federal Taxes Estimated ....................................... xx
   Show details of others ......................................... xx xx
   Dividends on Preferred Stock, Payable (date) ............... xx
   Dividends on Common Stock, Payable (date) ................. xx
   Matured Interest Coupon and Dividends ........................ xx

Total Current Liabilities ........................................... xx

RESERVES:
   Repairs and Renewals ........................................... xx
   Rent Received in Advance ....................................... xx
   Bond Premium Unextinguished ................................... xx
   Premium on Stock Issued ....................................... xx

Total Reserves ....................................................... xx

APPROPRIATED SURPLUS - WORKING CAPITAL DONATED .......... xx

PROFIT AND LOSS SURPLUS, per Exhibit "B" ..................... xx

TOTAL ............................................................... xx

Subject to Comments Contained in Our Report Dated February 5, 1931.
EXPLANATION OF PLATE 238

AN ACCOUNT FORM OF BALANCE SHEET (3rd type)

625. Explanation and Comments.--In the writer's opinion this arrangement is open to numerous criticisms. Both the captions "COMPANY'S SECURITIES IN TREASURY" and "LIABILITIES" could be improved on. The item of "Stocks and Bonds of Affiliated Companies" should be itemized. The "Reserve for Adjustment of Values" is unusual, but excellent. The inventories could be presented in a better order. The true prepaid assets should be taken out of the "DETERRED CHARGES TO OPERATIONS".

Objection is made to the separation of the capital items. No "TOTAL LIABILITIES" is arrived at. The nature of the items composing the "RESERVES" is widely dissimilar.

The following is the English form of balance sheet presentation:

<table>
<thead>
<tr>
<th>BANK OF MONTREAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Established 1817</td>
</tr>
</tbody>
</table>

Capital $36,000,000
Rest and Undivided Profits $39,246,856
Total Assets $769,166,272

STATEMENT AS AT 31ST OCTOBER, 1932

<table>
<thead>
<tr>
<th>LIABILITIES</th>
<th>ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital, Surplus and Undivided Profits</td>
<td>Cash on hand and due from banks and bankers</td>
</tr>
<tr>
<td>Deposits</td>
<td>$120,008,697.65</td>
</tr>
<tr>
<td>Bank's Notes in Circulation</td>
<td>Exchanges for Clearing</td>
</tr>
<tr>
<td>Bills Payable</td>
<td>$27,183,029.82</td>
</tr>
<tr>
<td>Letters of Credit</td>
<td>Bonds and Debentures</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>Stocks</td>
</tr>
<tr>
<td></td>
<td>$266,723,564.26</td>
</tr>
<tr>
<td></td>
<td>$618,288.17</td>
</tr>
<tr>
<td></td>
<td>$2,457,874.26</td>
</tr>
<tr>
<td></td>
<td>Call Loans outside Canada</td>
</tr>
<tr>
<td></td>
<td>Call Loans in Canada</td>
</tr>
<tr>
<td></td>
<td>$8,343,722.33</td>
</tr>
<tr>
<td></td>
<td>$20,071,135.74</td>
</tr>
<tr>
<td></td>
<td>$39,768,506.54</td>
</tr>
</tbody>
</table>

| Other Liabilities in Canada and Elsewhere | $302,931,269.80 |
| Bank Premises | $14,500,000.00 |
| Customers' Liability under Letters of Credit | $8,343,722.33 |
| ($'s per contra) | Other Assets |
| | $3,552,773.92 |

$769,166,272.69

$769,166,272.69
otherwise evoke comment and questioning. Naturally, the auditor who anticipates and answers legitimate questions in advance by a properly drawn up statement is the auditor who not only survives, but also prospers commensurately.

Although goods out on consignment may be included in the regular finished goods inventory, it is ordinarily better practice to state them separately, as, Inventories Out on Consignment, because this notation gives some additional insight into the client’s business, the knowledge of which may be invaluable to someone interested in the company.

Purchase commitments are not brought into the accounts unless the title to goods has passed to the client (purchaser), but the facts should always be reported in adequate detail as a foot-note. Too little information is generally given.

Advance payments on purchase contracts are not accounts receivables, but "Advance Payments on Purchase Contracts," -- an item suitably placed with or directly after the Inventories. Always give the amount of the contract.

In order to shorten the Auditors' Certificate, it is usually desirable to present the inventory qualifications in the inventory captions of the balance sheet itself by such designations as:

(a) Inventories - Book Value  (b) Inventories - Not Verified  (c) Inventories - As Taken by The Company  (d) Physical Inventories - At Cost or Market, Whichever Lower.  (e) Inventories - Retail Method.

Any allowance to reduce the inventories to a cost or market, whichever the lower, or other recognized basis, or for inter-departmental or inter-company profit, should ordinarily be taken from the gross inventory amount. But the amount should not be shown on the balance sheet. If, on the other hand, the allowance represents a conservative provision not actually required, as provided, for example, by the U.S. Steel in many instances, it should be placed among the surpluses.

Goods-in-transit at the audit date on which the title has passed to the client must be taken up on the books of account, including the liability therefor. If this item is omitted, there is, in the writer’s opinion, an essential misstatement.

Ordinarily, legitimate carrying charges on merchandise (such as storage, insurance, etc., to the extent that the total of all costs does not reach the sales price) are not shown separately, except in rare instances where to do otherwise would be equivalent to a deception.

(g) Temporary Investments.--Special care must be taken to see that these investments are indeed true current assets. If in special cases the cost value is used, the market value must be given parenthetically, or otherwise. It is preferable, if practicable, to show each security by name, instead of as a group.

If any securities are pledged, these should be indicated and the liability to which they apply should be named in full detail.

(h) Accrued Receivables.--If sizable in amount, the details should be itemized. Interest on items in default should not be accrued, unless, as in the case of a mortgage, the lien is amply sufficient for all.
(i) Prepaid Assets.--It is advisable to list the items falling under this caption in order that an interested party may be satisfied that these amounts are true current assets. Hence, such items as stripping costs, organization expense, and the like, must be rigorously excluded. These latter are Deferred Charges to Operations (Other Assets).

Office supplies are preferably included under this head, but factory supplies should always be classified with the other inventories, for the former never gets into the cost of the finished goods, whereas the latter enters the cost as an item of factory overhead.

It is only fair to remark, however, that many well-known auditing firms of first rank make no distinction between Prepaid Assets and Deferred Charges (Other Assets), or between Office Supplies and Factory Supplies. Some few firms treat Prepaid Assets as Current Assets.

(j) Permanent Investments.--This caption includes not only securities, but also any other assets properly falling within this category. Thus, for example, any vacant land held for investment is properly included hereunder. Land held by a realty company is usually a current asset.

If there is considerable difference between the book value and the actual intrinsic investment value, however determined, that fact should be shown in some way or other, preferably in parenthesis; thus:

Permanent Investments (at cost):

100 Comm. Shares, The Larco Mfg. Co (market value $8,250) . . $10,400
200 7% Preferred Shares, Arnold, Greene & Co. (market value $16,000) . . . . . . . . . . . . . . . . . . . . . . 20,000

(k) Sinking Fund.--Ordinarily, it is advisable to give in detail the items composing the fund, such as cash, securities and accrued interest. The securities should be fully described. Treasury stocks and/or bonds should be deducted from the outstanding amount(s) at par.

If the value of the securities is radically different from their carrying value, that fact must be brought out in some manner, preferably in a parenthesis notation.

A bond sinking fund may be deducted from the bonds payable.

(l) Investments in Subsidiaries.--Under this caption fall securities, advances, etc. Where a consolidated balance sheet is not presented, some idea of the intrinsic investment value of the securities should be given, however difficult this task may prove to be. If ascertainable, the market value should be given even though as a matter of fact the market would be depressed if the client were to unload the large number of shares now owned by it. Considerable ingenuity is needed, of course, in gathering and presenting evidence to be used in substantiating the value of securities in a closed corporation, or similar situation.

The composition of these investments in subsidiaries should practically always be disclosed in the fullest detail because of the great interest therein. Always state the per cent of control.

(m) Mortgages Receivable.--As a rule, mortgages are permanent investments -- not current assets -- because their maturity is generally more than one year after the audit date. Second mortgages and chattel mortgages should be designated as such. And if the mortgages (titles) are guaranteed by a guaranty company, the caption should indicate it.

1. Of course, many pieces of land and improved real estate held for sale are NOT current. 2. Average value if no-par-value stock.
(n) Plant Property.—Outside investments in real estate, etc., should not be carried under this caption but rather under Permanent Investments. It is always advisable, if practicable, to state the basis of valuation: i.e., depreciated cost, appraised sound value, etc. In the latter case, as much vital detail as possible should be given.

In regard to the advisability of showing the gross or the net additions (and deductions) to each main property account for the period, it may be stated that this procedure is usually an excellent one.

Expenditures for mere rearrangement of property should be classified under Other Assets (Deferred Charges), and thereafter written off as rapidly as possible.

Returnable containers, bottles, kegs, and the like (out with customers) are more in the nature of plant property than inventories (a current asset).

If machinery or any other property has been purchased without the title to it having passed to the client, a notation to that effect must always be made, preferably immediately after the description of the asset. In such cases, the asset less both the allowance for depreciation and the unpaid liability balance may be shown on the asset side of the balance sheet thereby presenting the legal aspect of the situation. Another common method is to show on the asset side the full property value with its depreciation allowance, and the unpaid balance among the secured current (or possibly fixed) liabilities. On the whole, this latter presentation is preferable, because to all intents and purposes the client has to meet this current liability in order to MAINTAIN and increase his present equity. The same sort of treatment is adaptable to cases where the client has bought a piece of property already subject to a mortgage whereby the mortgagor continues to look solely to the original mortgagor for the payments on the mortgage. Theoretically, only the client's equity (including, of course, the details thereof) should appear as an asset.

Practically, it is advisable to show the mortgage as a liability.

At the outset, donated land may either be mentioned in a foot-note, or it may be entered "short" among the plant items at its appraised value, or extended as an asset at $1. A fourth method shows the land as an asset, but less its valuation reserve (future capital surplus). As the land and the reserve accounts are always the same in amount, no value can be extended as an asset. Furthermore, there is no basis for showing the land as an asset at an increasing value proportional to the passage of the time stipulated in the contract. When/if the client fulfills the conditions necessary to acquire the title, the land can be carried as an asset at its appraised value, and the reserve as a capital surplus.

When uncompleted construction exists, it is accurate to show as an asset either the full amount of the contract less the deduction for the unpaid balance, or simply the amounts already paid to the contractor. If the latter procedure is adopted, a foot-note stating the gross amount of the contract is required. Although it is possible to show under suitable description the full amount of the contract as a fixed asset and the unpaid balance as a current liability, most auditors do not prefer this method to the other two methods just stated because in their opinion it does not show the facts. The title to the property has not passed from the contractor to the client, the building is not yet in complete existence, nor does the client owe, as yet, the unpaid balance.

If the client is doing its own construction, the amount necessary to complete the project must be stated, at least as a foot-note.
On rare occasions special care will have to be given to the approximate subdivision of the machinery into real and into personal property in an effort to show on the face of the balance sheet the amount of the machinery covered by a chattel mortgage bond issue (not a purchase money chattel mortgage).

Molds, patterns, drawings, dies and the like, should be placed along toward the last of the Plant Property items. As the values tied up therein are often very fleeting -- here today, gone tomorrow -- they obviously rank just one step ahead of the Intangibles.

Idle property, or land held as a possible future site, should often be stated separately.

(o) Allowances for Depreciation. -- The allowance for depreciation is usually carried in allowance accounts rather than as credits direct in the property accounts. Very common exceptions to this are the Tools account, and the Patents account in the case of the amortization of Intangibles.

These allowances should be deducted from the assets on the face of the balance sheet, either in toto or in detail. If the amount of the allowances have little or no relation to the proper amount as evidenced by wear and tear, obsolescence, inadequacy, etc., there can be no objection to showing them on the right-hand side of the account form of balance sheet, but the mistake must not be made of regarding them as surpluses, unless they exceed the amount of accrued depreciation.

In some few cases it is desirable to show the changes in the allowance accounts.

(p) Goodwill, Patents, Franchises, Trade-Marks, Etc. -- Obviously, the main canon of good accounting procedure is that these items be separated from the tangible plant property.

Where feasible, goodwill should be stated by itself. If the goodwill has been arbitrarily established at appraised values, the balance sheet caption, such as - Goodwill - (appraised value) . . . $2,000,000 --, must be clear on that point inasmuch as it is an incorrect accounting procedure merely to establish the account at will. The same requisite is urgent whenever the account has been written down substantially, at least on the first balance sheet prepared under this situation. Thus it may be stated as, Goodwill (cost $1,000,000) . . . . $1.

The Federal Reserve Board has shown the Goodwill account on its balance sheet as a deduction from networth. The idea is clearly that the goodwill must speak for itself via excellent profits per the Profit and Loss Statement, whereas ordinarily the client tries to speak for the goodwill, as it were.

(q) Other Assets. -- This caption is not as common as Deferred Charges to Operations. As Kester says, "Almost invariably some items are found among the assets which do not lend themselves to exact classification under any of the standard groups. Thus there are often accounts receivable which are not current items, nor can they be classified as investments or fixed assets. It is best, therefore, except where great condensation is desirable, to list all items of this kind in a final miscellaneous group entitled, Other Assets. The group is not homogeneous; no uniform principles

1. See Appendix C, Sec. 15-#2.
or formulae of valuation apply; each item in it must be treated individually. Bond discount should, therefore, usually be shown here. Discount on capital stock, if shown among the assets, belongs here also. And finally, the intangible item, organization expense, is best included in this miscellaneous group.\(^1\)

\(r\) Contingent Assets.—Usually it is sufficient to enter the contingent assets as a foot-note, or in "short", on the balance sheet rather than in offsetting accounts. But some contingent assets, such as notes receivable which have been discounted (which also gives rise to a corresponding contingent liability), are properly treated by entries in OFFSETTING accounts.

\(s\) Notes Payable.—Notes payable should first of all be divided into two main groups; namely, those which are secured and those which are not secured. For credit, or for internal management purposes, the secured obligations should be divided into (a) those secured by equipment or other plant property (b) those secured by liens on inventories, (c) those secured by assigned customers' accounts, (d) those secured by deposits of securities, and (e) those secured by __(specify__)_. Likewise, all unsecured notes should be detailed somewhat as follows: (a) notes payable to banks for money borrowed, (b) notes sold through note brokers, (c) acceptances and notes given for merchandise, raw materials or supplies, (d) notes given to subsidiaries or parent companies for money borrowed, (e) notes given for plant properties, (f) notes given to subsidiaries or affiliated parent companies in the ordinary course of purchases, and (g) notes due to stockholders, officers, or employees. Moreover, if there is any sizable amount of overdue notes, these must be designated in some manner; such as:

Notes Payable—Trade (overdue $51,800.14) . . . . . . . . $217,619.45

In some instances it may be necessary or desirable to show very large notes (in comparison to the others) in full detail.

\(t\) Accounts Payable.—The secured liabilities must always be distinctly separated from the unsecured. Likewise, those debts payable to the trade must be separated from those due to stockholders, officers, subsidiaries, employees, etc. In many instances the amount of past due, or very large accounts must be indicated.

Customers' credit balances, if small, may be included hereunder, provided always that they are in the nature of accounts payable. Customers' credits arising from advance receipts against future sales, for example, must NOT be included. They are Advances on Sales Orders.

If no allowance is made at the audit date for possible cash discounts on sales, none should be made for the discounts on purchases.

If any accounts payable, together with its related asset, is omitted, such as goods-in-transit at the audit date, this fact must be made a foot-note.

\(u\) Dividends Payable.—The details of this account should be shown, such as: Preferred Dividend Payable, 7\%, due Jan. 15th . . . . . $xx.

\(^1\) Kester, Volume 2, P. 364.
(v) Accrued Payables.--In most instances the composition of this amount should be itemized, except, for example, in condensed statements. It is particularly important that the current provision for federal taxes be treated as a current liability. Too often, auditors allow the client to dictate the position (fixed liability section) where this account shall be placed. No part of this sum should be considered "fixed".

If the client has not made ample provision for all accruals, the auditor must note that fact somewhere on the balance sheet.

(w) Deferred Income.--As deferred income items are not ordinarily payable in cash or goods, and as the amount at which they are stated on the balance sheet includes an element of profit, it is not ordinarily advisable to treat them as current liabilities, unless (1) the prepaid assets have been classified as current assets, or (2) the deferred income is payable with goods included in the current inventories, as when a gasoline station has unpresented coupons outstanding. However, deferred income items which represent obligations to be discharged within one year are so like current liabilities as to require their being set up directly after them. Deferred income which will not be earned until after one year from the date of the balance sheet should be regarded as a long term liability.

(x) Long Term Liabilities.--Under this heading one often finds:

(1) Deferred Income which represents income that will not be earned until AFTER one year from the balance sheet date.
(2) Deferred Credits which will offset future expense charges (see Section 555).
(3) Deposits which by contract or otherwise cannot be withdrawn by the depositor, or are not likely to be withdrawn until AFTER one year from the balance sheet date.
(4) Bonds, debentures, long-term notes, certificates of indebtedness, mortgages, and any other similar obligations secured or unsecured, which mature AFTER one year from the balance sheet date.

As has been noted hereinbefore, treasury bonds should be subtracted at par from the outstanding amount, or stated as Treasury Bonds at values applied to temporary investments (Sec. 229) if shown as assets. This latter presentation, to reiterate, is not desirable unless the amount of bonds is small and unless they can be disposed of.

Uncovered serial installments should be shown as current liabilities if they become due within approximately one year from the date of the balance sheet date. Under the same circumstances, the same treatment should be accorded the whole of a matured bond issue, except that if the debt is to be renewed, assuming that in fact it can be renewed if desired, it may be shown in its usual "fixed" position as a long-term debt. Even if the auditor is in doubt as to the possibility of its being able to be renewed, no canon of good accounting procedure is violated, provided the maturity date and all other essential particulars are given in full on the balance sheet. On the other hand, if the bonds are funded, the fund of assets (if it is not treasury bonds) may be listed as a current asset, provided the indebtedness is listed as a current liability. Usually, however, it is better to leave a maturing FUNDED (i.e. covered) issue and its sinking fund alone in their original "fixed" positions.
Within reason the fullest possible description of a bond issue should be given even if it necessitates a foot-note. Included therein should be the maturity date (or dates if serial), the interest date, the nature of the property pledged, the nature of the lien, the amount of bonds authorized, issued, in the treasury and pledged, the possibility of conversion into stock, and so on. (However, see foot-note below).

See Plate 188.

(y) Contingent Liabilities.--As this topic is too vast in scope to be summarized hereunder, reference should be made to Chapter 36. However, it may be noted that there are four common practices of balance sheet presentation, thus: (a) the contingent asset (if any) and the contingent liability may be treated as a real asset and as a real liability; (b) the "liability" may be deducted from the gross asset thereby leaving the net amount to be extended as an asset; (c) an asterisk may be placed against the type of asset concerned thereby calling attention to a foot-note; (d) the contingent liability may be entered "short" in the proper place among the liabilities.

(z) Networth.--Here again the subject matter is too complicated to be condensed briefly, hence reference should be made to Chapters 29, 41, 42, and 43, and particularly to plates 192, 203, 204, and 206.

---

1. "Mortgages on real estate appear among the liabilities and should be identified when possible with the property subject to the mortgage. It is not customary, however, nor is it good accounting practice, to note against the assets that they are subject to mortgages nor to specify on the liability side what property has been mortgaged. The reason for this -- and probably it is a sufficient one -- is that the liens and hypothecations which trouble general creditors are those against personal property -- usually current assets. General creditors do not expect to realize the equity in real property when real estate mortgages are shown on the balance sheet.

When debenture and other bonds purport to be a lien on current assets, the auditor should seek legal advice as to whether the fact should be set forth on the balance sheet or not." -- Montgomery, P. 440.
827. Examples of Internal Presentation.¹

These examples are not to be taken as models; some of them are very poor.

(a)

CASH:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>In Banks</td>
<td>$469,486.17</td>
</tr>
<tr>
<td>On Hand</td>
<td>45,000.00</td>
</tr>
<tr>
<td>On Deposit</td>
<td>-1,545,000.00</td>
</tr>
<tr>
<td>(For payment of matured first mortgage 6% sinking fund gold bonds and interest)</td>
<td></td>
</tr>
<tr>
<td>On Deposit</td>
<td>250,000.00</td>
</tr>
<tr>
<td>(For dividends payable Jan 15, 1932)</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$2,309,486.17</td>
</tr>
</tbody>
</table>

(b)

ACCOUNTS RECEIVABLE (Circularized):²

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Due from the Harpet Print Works, Inc.</td>
<td>$185,496.28</td>
</tr>
<tr>
<td>Other Customers</td>
<td>$231,642.45</td>
</tr>
<tr>
<td>Less-Allowance for Doubtful Accounts</td>
<td></td>
</tr>
<tr>
<td>Net</td>
<td>$417,138.73</td>
</tr>
<tr>
<td>Accrued Income</td>
<td></td>
</tr>
<tr>
<td>Creditors' Debit Balances</td>
<td></td>
</tr>
<tr>
<td>Officers and Employees</td>
<td></td>
</tr>
<tr>
<td>Acceptances</td>
<td>$xx</td>
</tr>
<tr>
<td>Trade Notes</td>
<td>xx</td>
</tr>
<tr>
<td>Accounts Receivable - Trade (Past due $xx)</td>
<td>xx</td>
</tr>
<tr>
<td>Total</td>
<td>$555,209.76</td>
</tr>
</tbody>
</table>

(c)

Less-Reserves:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discounts</td>
<td>$xx</td>
</tr>
<tr>
<td>Bad Debts</td>
<td>$xx</td>
</tr>
<tr>
<td>Others</td>
<td>$xx</td>
</tr>
</tbody>
</table>

(d)

Accounts Receivable - Trade (net of reserves $xx) - $xx

1. To repeat, as many qualifications and comments as possible including the basis of valuation of each group of assets, should be written into the face of the balance sheet in preference to putting them in the Certificate.

2. It is the consensus of opinion that in the case of small businesses, the auditor should state whether or not the accounts have been circularized.
### Accounts Receivable - Trade (Net):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pledged on Notes Payable - Officers (Contra)</td>
<td>$58,463.29</td>
</tr>
<tr>
<td>Due from Subsidiaries</td>
<td>$128,429.76</td>
</tr>
<tr>
<td>Due from the U.S. Steel Wire Corp.</td>
<td>95,107.23</td>
</tr>
<tr>
<td>Others</td>
<td>$80,915.42</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$362,935.70</td>
</tr>
</tbody>
</table>

### Trade Notes and Acceptances Receivable:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collateral Notes (Market Value $xx)</td>
<td>$xx</td>
</tr>
<tr>
<td>Regular</td>
<td>$xx</td>
</tr>
<tr>
<td>Due from the Charlotte Merrill Mills, Inc.</td>
<td>$xx</td>
</tr>
<tr>
<td>Total</td>
<td>$xx</td>
</tr>
<tr>
<td>Others</td>
<td>$xx</td>
</tr>
</tbody>
</table>

### Notes and Acceptances Receivable:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pledged against Notes Payable - Banks ($xx)</td>
<td>$xx</td>
</tr>
<tr>
<td>Unpledged</td>
<td>$xx</td>
</tr>
<tr>
<td>Total</td>
<td>$xx</td>
</tr>
<tr>
<td>Less - Discounted</td>
<td>$xx</td>
</tr>
<tr>
<td>Net</td>
<td>$xx</td>
</tr>
<tr>
<td>Less - Reserve</td>
<td>$xx</td>
</tr>
<tr>
<td></td>
<td>$xx</td>
</tr>
</tbody>
</table>

### Physical Inventories (as taken by the Company at "Cost or Market"):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finished Goods on Hand</td>
<td>$xx</td>
</tr>
<tr>
<td>Out-on-Consignment</td>
<td>$xx</td>
</tr>
<tr>
<td>Goods-in-Process</td>
<td>$xx</td>
</tr>
<tr>
<td>Raw Materials (pledged - contra)</td>
<td>$xx</td>
</tr>
<tr>
<td>Supplies</td>
<td>$xx</td>
</tr>
<tr>
<td>Advances on Raw Materials Not Received:</td>
<td>$xx</td>
</tr>
<tr>
<td>Contract Price</td>
<td>$xx</td>
</tr>
<tr>
<td>Less - Unpaid Balance (not due) (Market Value $xx)</td>
<td>$xx</td>
</tr>
<tr>
<td>Advanced</td>
<td>$xx</td>
</tr>
</tbody>
</table>

### Merchandise Inventory (At Cost):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$269,412.82</td>
</tr>
<tr>
<td>Less - Received-on-Consignment</td>
<td>$243,976.34</td>
</tr>
<tr>
<td>Net - (Market Value $44,436.48)</td>
<td>$44,436.48</td>
</tr>
</tbody>
</table>

### Marketable Securities (At "Cost or Market"):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>240 Common Shares, U.S. Cotton Mills, Inc. (Market $xx)</td>
<td>$xx</td>
</tr>
<tr>
<td>50 7% Preferred Shares, Bartlett, Inc. (Market $xx)</td>
<td>$xx</td>
</tr>
<tr>
<td>Total</td>
<td>$xx</td>
</tr>
</tbody>
</table>
### Permanent Investments:

- **Real Estate** (1929 Net Profit - $19,154) ...
  
  $189,658.42

- **Less Depreciation** ... ...
  
  48,963.28

- **Bonds at Adjusted Cost:**
  
  - **The Chico Corp.** - Par $140,000; 1st Mtg. 7% (Market $145,000) 142,500.00
  
  - **The Martex Company** - Par $150,000; 1st Mtg. 6% (Market $148,500) 150,500.00

  **$433,698.14**

### Treasury Stock (Market $xx)

(Balance of donated stock provided for working capital - 1125 shares)

### BOND SINKING FUND (Exhibit A-4): ...

(Cash, securities and interest; Treasury bonds deducted contra)

### Sinking Fund for Redemption of Long-Term Debt:

- **Cash** ...
  
  $xx

- **Bonds (market $xx) (Treasury bonds contra)** ...
  
  $xx

- **Total with the Chase National Bank, Trustee** ...
  
  $xx

### Investments in the Theriody Mfg. Co. (at cost):

- **Capital Stock** - 1500 shares par $50 each (85% control) ...
  
  $xx

- **First Mortgage Bonds** - par $150,000.00 (Auth. $500,000) ...
  
  $xx

- **Advances** ...
  
  $xx

### Plant Property, Less Reserves -- Schedule #2 ...

$xx
### PLANT PROPERTY:

<table>
<thead>
<tr>
<th>Description</th>
<th>Gross</th>
<th>Reserve</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Less - Donated Reserve</td>
<td></td>
<td>$xx</td>
<td>$xx</td>
</tr>
<tr>
<td>Buildings</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Machinery</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Tools, Inventory</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Horses, Wagons, and Harness, Inventory</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Autos and Trucks, Inventory</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Inventories of Plant Replacement Parts</td>
<td></td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Total</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
</tbody>
</table>

Cash for Construction of Plant E (contract $xx)  

### PROPERTY:

<table>
<thead>
<tr>
<th>Description</th>
<th>Gross</th>
<th>Reserve</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land (To be received as a donation. Appraised at $xx)</td>
<td></td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Buildings</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Machinery</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Tools</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Furniture and Fixtures</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Containers</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Automobiles, Trucks, Horses, Wagons, Harness</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Molds, Patterns, Drawings, Etc.</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Total</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
</tbody>
</table>

Less-Allowances for Depreciation  

### PROPERTY:

<table>
<thead>
<tr>
<th>Description</th>
<th>Jan. 1</th>
<th>Additions</th>
<th>Dec. 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$xx</td>
<td>$xx</td>
<td>$xx</td>
</tr>
<tr>
<td>Buildings</td>
<td>$xx</td>
<td>$xx</td>
<td>$xx</td>
</tr>
<tr>
<td>Machinery</td>
<td>$xx</td>
<td>$xx</td>
<td>$xx</td>
</tr>
<tr>
<td>Tools</td>
<td>$xx</td>
<td>$xx</td>
<td>$xx</td>
</tr>
<tr>
<td>Furniture and Fixtures</td>
<td>$xx</td>
<td>$xx</td>
<td>$xx</td>
</tr>
<tr>
<td>Autos and Trucks</td>
<td>$xx</td>
<td>$xx</td>
<td>$xx</td>
</tr>
<tr>
<td>Total</td>
<td>$xx</td>
<td>$xx</td>
<td>$xx</td>
</tr>
</tbody>
</table>

Less - Reserves  

### MACHINERY (Title with Vendor)

<table>
<thead>
<tr>
<th>Description</th>
<th>Gross</th>
<th>Reserve</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>MACHINERY (Title with Vendor)</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Less - Allowance for Depreciation</td>
<td></td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Net</td>
<td>$xx</td>
<td></td>
<td>$xx</td>
</tr>
<tr>
<td>Less - Purchase Money Notes</td>
<td></td>
<td></td>
<td>$xx</td>
</tr>
</tbody>
</table>
Deferred Charges:
- Doubtful Accounts Receivable: $xx
- Organization Expenditures: xx
- Unamortized Bond Discount and Expense: xx
- Experimental Expense: xx

Other Assets:
- Unamortized Depreciation of Plant: $xx
- Cash in the Robinson National Bank of Saco, N.Y.: xx
- Miscellaneous: xx

Deferred Charges to Operations: $1,307.14

Expenditures Applicable to Future Operations: $xx

Goodwill, Patterns, Trademarks: $1.00

Goodwill (Cost $1,050,000): $1.00

Goodwill (at cash cost): $25,000.00

Deficit:
- Profit and Loss Deficit, per Exhibit B: $xx
  - Less: Premiums on Sales of Common Stock: $xx
  - Capital Surplus Arising from Appraisal of Plant Property: xx

1. Whenever capital stock has been issued for plant or intangibles, it is good practice for the auditor to state parenthetically on the balance sheet that the asset was acquired in exchange for stock.
NOTES PAYABLE:

Secured:
- By Machinery ($xx).
- By Inventories ($xx).
- By Securities ($xx).

Unsecured:
- Payable to Banks ($xx).
- Sold through Note-Brokers (xx).
- Payable to Subsidiaries (xx).
- Payable for Merchandise (xx).

Accrued Payables:
- Salaries and Wages (xx).
- Commissions (xx).
- Local Taxes (xx).
- Interest (xx).

CURRENT LIABILITIES:
- Notes and Acceptances Payable ($xx).
- Accounts Payable (xx).
- Bank Overdraft (xx).
- Customers' Credit Balances (xx).
- Matured Five-year 5 1/2% Gold Notes (xx).
- Accrued Payables (xx).
- Matured Interest on 6% Funded Debt (xx).

Accounts Payable ($xx).
- Less - Purchase Discounts Available (xx).

Accounts Payable:
- Past Due ($145,814.86).
- Current (102,986.27).
- Due the Chattanooga Stove Works, Inc. (78,417.76).
- Total ($327,218.89).

Deferred Credits ($2,406.27).
DEFERRED CREDITS:

Premiums on Funded Debt
Unearned Rentals

FIRST MORTGAGE, 7% GOLD BONDS, DUE 1960:

Authorized
Less - Unissued
Retired by Trustee
In the Treasury--Pledged to Secure Notes
Payable - Banks ($xx)
Outstanding

MORTGAGES ON REAL ESTATE - Schedule #3

CONTRACT OF PURCHASE - PLANT E
(Payable at the rate of $50,000 per month after Feb. 28, 1932)

FIXED LIABILITIES:

Deferred Income
7% First Mortgage Sinking Fund Serial Bonds-1960
Bond Premiums

RESERVES FOR CONTINGENCIES (Exhibit A-7):

Injuries and Damages
Insurance
Pensions

CAPITAL:

Capital Stock-1000 shares authorized and outstanding, par $100
Surplus, per Exhibit B

1. The preferred treatment is as in (d) below.
2. All changes in RESERVES during the year must be thoroughly disclosed either in the report, or if none, then on the balance sheet. Furthermore, the reserves must be properly classified on the balance sheet.
CAPITAL:

Capital Stock:
- Preferred -(6% non-cumulative, authorized 10,000 shares, par $50)...
- Common -(Authorized 30,000 shares, Par $100)...
Total Stock Outstanding.......

Surplus:

Earned:
- Balance, January 1, 1930...
- Profit for the Year (Exhibit B)...
- Total...
- Less - Federal Income Tax - 1930...
- Dividends (6% on Preferred; 10% on common)...
- Net...

Capital:

- Paid in on Common Stock...
- Profit on Sale of Plant B - Sarlesville, Conn...

CAPITAL SURPLUS...

(a)

(From the revaluation of goodwill and trademarks)

(b)

CAPITAL SURPLUS:

- From Donated Land...
- From Donated Treasury Stock...
- From Appraisal of Plant Properties...

(a)

Note: As at November 30, 1931 the Company had contingent liabilities on account of drafts and bills negotiated under bankers' letters of credit against purchases of merchandise in the amount of $10,300,000.00

(b)

Note: As at April 30, 1931 the Company had a contingent liability as guarantor of principal and interest on $10,000,000 First Mortgage, 7½ Gold Bonds of the Trask Manufacturing Co.

(c)

Note: The Company has a contingent liability of $6,309,418.29 on account of discounted trade notes and acceptances receivable.

(d)

Note: The Company had $1,514,612.67 worth of goods-in-transit, terms f.o.b. this Company's plant, the market value of which was substantially cost.

(e)

Note: As at November 30, 1931 there was $486,397.93 worth of goods-in-transit (terms f.o.b. vendor's plant) omitted both from the inventories and the payables.
Balance Sheet Adjustments and Modifications: "Has the auditor the right to influence his December 31st report by knowledge which he acquires after that date?"

Answer: "--- 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." - - Journal of Accountancy, (Sept. 1931, p. 233).

Balance Sheet Practice - Summary: "The following is taken from a bulletin ("Financial Statements in Annual Reports to Stockholders") prepared by the Policyholders Service Bureau of the Metropolitan Life Insurance Co:

'Balance sheets will vary considerably from industry to industry and among various companies in any one industry. A balance sheet is a highly condensed presentation of a company's resources and obligations at a given date and is supplemented in the body of the annual report itself. Among the practices observed in the investigation of balance sheets, which may be of interest to executives, are the following:

1. That the terms or items are simply defined.
2. That results are stated comparatively in some balance sheets for at least two years.
3. That the basis upon which property is valued is given.
4. That the amount of depreciation and similar reserves is stated.
5. That the accounts receivable show to what extent the company is in the installment business.
6. That the accounts and notes receivable are safeguarded by adequate reserves for bad debts.
7. That the amount of these reserves is made known.
8. That inventories are reasonably classified, and the basis of valuation of these inventories shown.
9. That where inventories are valued at less than cost or market, the basis for such valuations is revealed, as well as any reserves for inventory losses.
10. That current liabilities are set forth fully.
11. That particulars are stated as to funded or long-term obligations including maturity dates, coupon rates, etc.
12. That other liability reserves are classified and, by their caption, give some clear idea of their purpose.
13. That earned surplus is segregated from paid-in-surplus or surplus arising from revaluation of assets.
14. That the kinds of capital stock are classified in sufficient detail.
15. That a notation is made of all contingent liabilities."1

1Paton, "Accountants Handbook", p. 21
The following illustrations are presented for criticism. Some are excellent, whereas others are very poor.

\[(1-a)\]

Land, Buildings, Machinery and Equipment \ldots \$238,668,605.27
Less - Mortgage not assumed\(^1\) \ldots 4,078,500.00 \quad 234,590,105.27

\[(1-b)\]

**Funded Debt of Subsidiary Companies**

First Mortgage Bonds -
- Due February 1, 1937, 6% \ldots \$ 1,165,000.00
- Due July 1, 1941, 5% \ldots 3,362,000.00
- Due July 1, 1950, 6% \ldots 316,000.00
- Due October 1, 1955, 5% \ldots 3,664,000.00

Mortgages on Real Property--
- Due December 14, 1932, 5 1/2% \ldots 100,600.00
- Due April 1, 1945, 5 1/2% \ldots 237,500.00

Debentures -
- Due April 1, 1958, 5% \ldots 706,650.00

\[ \text{TOTAL FUNDED DEBT} \ldots \ldots \ldots \ldots \ldots \quad \$ 9,554,150.00 \]

\[(1-c)\]

**Current Assets**

Capital Stock of Union Carbide and Carbon Corporation (36,105 shares at cost) \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldot

\[ \text{Inventories of raw materials, goods in process and finished goods, certified by officials of the Company as to quantities and condition, valued at the lower of cost or market} \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldot

\[ \text{\(^1\) "The Corporation during the year acquired title to the 95 year ground lease and thirty-seven story Carbidc and Carbon Building, 230 North Michigan Avenue, Chicago, Illinois, and to the fee of the land and sixteen story building located at 300 Madison Avenue, New York City, subject to underlying first mortgages totaling $4,100,000 and to an unpaid balance of $12,500 under an outstanding second mortgage. These mortgages now aggregating $4,078,500 were not assumed and are, therefore, not included in the Consolidated Statement as a part of the funded debt or as a liability, but do appear in the Consolidated Statement as a deduction from Fixed Assets." --1930 Annual Report of Union Carbide and Carbon Corp. \]

\[ \text{\(^2\) 1931 Annual Statement of Hershey Chocolate Corp.} \]
WORKING ASSETS:
Supplies and repair parts .......................... $210,759.89
Salesmen's Advances, Prepaid Insurance, etc. 175,029.74 $366,789.63

CAPITAL STOCK AND SURPLUS:
Convertible preference stock (without par value) authorized and issued 350,000 shares of which 56,620 shares have been converted into common stock. Issued and outstanding 293,180 shares at stated value (see note) .................................. $293,180.00

NOTE: The convertible preference stock is entitled to cumulative dividends at the rate of $4.00 per share per annum, plus an extra dividend of $1.00 per share in any year in which dividends are declared or paid on the common stock. Upon any distribution of capital assets the convertible preference stock is entitled to receive $50.00 per share and accumulated unpaid dividends (if any) before any distribution to the common stock and shares equally per share with the common stock in any distribution of the balance until the convertible preference stock received a total of $100.00 per share and accumulated unpaid dividends (if any).

PLANT AND PROPERTY
Construction in Progress ................................ $114,034.22

Surplus at organization ................................ $2,793,596.99

Trade customers, less reserves:
Domestic ............................................. $56,666.16
Foreign ................................................ 143,911.10

 Marketable securities (corporate stock notes of the City of New York due January 20, 1932), at cost (pledged as collateral for bond given to secure payment of judgment, pending appeal, for which reserve has been provided) .......................................................... $150,087.04

---

1 1932 Annual report of Pathé Exchange, Inc.
Ten-year 7½ Sinking Fund Gold Debentures due May 1, 1937:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorized</td>
<td>$10,000,000.00</td>
</tr>
<tr>
<td>Issued</td>
<td>$6,000,000.00</td>
</tr>
<tr>
<td>Less - Retired and cancelled</td>
<td>1,260,000.00</td>
</tr>
<tr>
<td>Outstanding</td>
<td>$4,740,000.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash in sinking fund</td>
<td>$8,000.00</td>
</tr>
</tbody>
</table>

Debentures held in treasury at face value (of which $30,000.00 was held by Escrow agent at January 2, 1932 as security under the terms of agreement with Radio-Keith-Orpheum Corporation now held in treasury):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,003,000.00</td>
<td>2,011,000.00</td>
</tr>
<tr>
<td></td>
<td>2,729,000.00</td>
</tr>
</tbody>
</table>

Contingent Liability:

In respect of possible additional royalties which, in the opinion of the Company's officials, will not exceed $150,000.00.

Investments:

Capital stock of Du Pont Film Manufacturing Corporation, as valued by the Board of Directors in 1931: $4,000,000.00

Capital surplus balance (including credits in respect of appraisals of properties and investments and reductions of capital stock; after reduction of deficit) as per Exhibit B: $2,390,896.78

Add-Other Income:

Discount on ten-year 7½ sinking fund gold debentures purchased for retirement, less unamortized discount and expense applicable thereto ($139,689.02 represents net discount on debentures held in treasury at January 2, 1932): $159,114.02

Appropriations to Reserves:

To provide for estimated future loss on disposal of idle, surplus, obsolete and excessively cost-valued Property, Plant and Equipment, and the writing down of appreciation due to past independent appraisal of properties. (This amount has been credited to the "Reserves for Depreciation"). See note (a): $9,750,000.00

---

To provide for the adjustment in value of securities to at least the market value thereof at December 31, 1931. (This amount has been deducted from "Marketable Securities" and therefore from Current Assets.)

See note (b)

To provide for the writing down to the United States dollar basis of the net current assets of foreign subsidiaries, remaining in foreign countries. Current Assets and Current Liabilities have been adjusted downward by this amount. (Exchange losses on current transactions have been absorbed in 1931 operating results).

See note (c).

Note: (a) - Normal growth and progress, scientific research and development, improved technique and operating efficiency call for constant study and survey of the physical assets employed in the processes of production and distribution. Such studies never cease to indicate the wisdom of changes, additions, substitutions and consolidations, which in turn bring about a measure of obsolescence and idleness and, therefore, scrapping or other disposition of plants and equipment affected. The foregoing is true at all times and under ordinary conditions, but to a much greater degree following such a program of expansion and diversification as this Company has engaged in during the past four years, during which time we have acquired many fine businesses in the United States and Canada, with their physical assets and methods geared to their particular individual requirements.

Co-ordination of activities and standardization of practice takes on a new and added importance under such conditions and at such a time if the potential benefits and advantages of such a policy are to be realized. We have done much and accomplished much along these lines. We have definitely planned and are engaged in the doing of much more, all aimed at greater efficiency and co-ordination of operations, with utmost protection of quality.

As a consequence of all of the foregoing the adjustments of book values of Property, Plant and Equipment, as set forth on page 15 of this Report, and aggregating $9,750,000.00, have been made.

These adjustments comprehend the effect on book values to date of the carrying out of such a plan and, as well, the estimated similar effect on values that now seem likely of experience in the near future. They have the further effect, when taken together with property sales so far effected, of relieving operations of depreciation charges as affecting this class of properties, but without lowering of the depreciation rates used.

Note (b) - The special provision of $1,625,000.00 made and shown on page 15 of this Report for the writing-down of Marketable Securities owned to their market value on December 31, 1931, conforms to, and is consistent with, our long established practice of treating the adjustment of such Assets as a Surplus item.

The profits realized on the sale of Marketable Securities during very recent years, which profits were credited directly to Surplus, have considerably exceeded the provision for their December 31, 1931 adjustment now charged to Surplus.
These securities are of high investment rating, a large proportion being United States Government securities. There is little likelihood of need for their immediate conversion into cash. There is likelihood of their market value being restored to at least their previously carried book value, which last reported value was below the then market value. In such an event, the appreciation enjoyed will, of course, not be reflected in then current income, but treated, as now and heretofore, as an adjustment of Assets and, therefore, a credit to Surplus.

Note (c) -- Such exchange losses as have anywhere been currently experienced, together with estimated exchange losses on forward contracts made in terms of foreign exchange at par, (although such contracts will not be finally consummated before March 31, 1932) have been charged to 1931 operations. Further similar losses, if any, will, of course, be charged currently.

The earnings of foreign subsidiaries are currently depreciated to United States dollar value, thus becoming a charge to current operations, irrespective of whether such earnings are transferred to the United States or allowed to remain in foreign jurisdictions.

It is thus seen that 1931 operations have absorbed, and future operations will absorb, all exchange losses of a current nature.

Over and above, and apart from these current charges, currently taken, special provision for Balance Sheet purposes was made to the amount of $954,262.83, as shown on page 15 of this Report, for the adjustment to their United States dollar value on December 31, 1931 of the aggregate net current assets of foreign subsidiaries then remaining and in operating solely within foreign countries (almost all of which are in Canada).

These assets are solely employed and converted into finished products, and the sales thereof almost wholly confined to the country in which the assets are located.

In the event of exchange being restored to par or stabilized on a basis higher than rates employed in their depreciation on December 31, 1931, the resulting appreciation of book values of these net current assets then remaining would become a direct return to Surplus, without any effect on the then operating income.

\[(5-a)\]
Current Assets:
Installment notes due in 1932 \(\ldots \ldots \ldots \ldots \ldots \) $1,223,117.54

\[(5-b)\]
Advances and Miscellaneous Investments:
Advances to customers and instalment notes
and accounts, less reserves \(\ldots \ldots \ldots \ldots \ldots \) 7,843,560.29

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1 1931 Annual Report, McKesson & Robbins.
Balance of Common Stock of No Par Value and Capital Surplus, December 31, 1930 (1,074,721 shares)...

Add: Rights converted during the year into 13 shares of common stock...

Deduct:

- Trade and miscellaneous investments acquired at organization of the company, etc. -- charged off...
- Net difference between amounts collectible under guaranty agreements which have been settled, and amounts estimated at date of organization of the company...
- Organization expenses, goodwill, etc., charged off in 1931...

Less: Dividend December 15, 1931 on preference stock—paid out of capital surplus per resolution of Directors...

Balance, December 31, 1931 (1,074,734 shares)...

Current Assets:

Balances on Deposit in Closed Banks, less Reserve ($80,000)...
Marketable Securities — at cost (Market Value December 31, 1931, approximately $4,080,250.00):
- U. S. Government Bonds...
- Other Bonds...

Marketable Securities:

Stocks and Bonds — at Cost — Less Depreciation Reserve...

Note: Net Loss on sales of Securities to the amount of $1,023,022.92 has been charged to the (general) Reserve previously accrued.

Insurance Fund:

U. S. Government Securities...

1. 1931 Annual Report, Borg-Warner Corp.
3. 1930 Annual Report, United Fruit Company.
Capital:

Add: 300,000 shares of Capital Stock issued for net assets of Guyamel Fruit Company and Surplus accruing therefrom. .......... $23,268,619.31

Furniture and appliances (other than in factories) .......... 1.00
Patents ....... 1.00

Marketable securities (at lower of par or market) .......... 7,122,620.00

Associated companies and miscellaneous securities ..... 179,308,010.36

Investments in associated companies are of a more or less permanent character, and may well be considered as investments in plant and working capital of companies closely associated with your Company in the development of its business on a broader base and in a more effective manner than could be done by your Company itself. Accordingly, investments in associated companies in which your Company has a majority interest are appraised on a basis similar to that used in the valuation of your Company's assets. Investments in other companies are appraised after consideration of cost, net worth, return on investment, market price, if any, and foreign exchange, but in no case is an investment or security appraised at a higher valuation than the market price on a recognized exchange on December 31, 1931, with due allowance for foreign exchange rates.)

Cost of present plants ........ 199,129,732.92
General plant reserve and depreciation.
December 31, 1930 .......... $152,436,033.08
Added by charges to income during 1931. .......... 8,659,062.05
Proceeds from sale of dismantled equipment, etc., during 1931 .......... 546,022.07

Less:Cost of plants dismantled, sold or otherwise disposed of during 1931. .......... 8,774,403.54
Net Book Value, December 31, 1931 .......... $ 46,061,019.26

Inventories at Cost which is substantially market:

Finished Cars ........................................ $604,246.42
Raw Material, Work in Process, Finished Parts and Supplies 4,249,712.23

Less Reserve for Contingencies and elimination of Inter-Company Profit 400,000.00

Prepaid Expenses and Deferred Charges:

Insurance ........................................ 31,752.82
Show Expense ..................................... 15,123.10
Plant Rearrangement ................................ 14,516.30
Unamortized Discount on Subsidiary Funded Debt 19,357.96
Sundry ........................................... 1,927.66

Plant Assets:

<table>
<thead>
<tr>
<th>Plant Assets</th>
<th>Book Value</th>
<th>Depreciation</th>
<th>Reserve for Depreciation</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$2,456,017</td>
<td>$2,456,017</td>
<td>$2,456,017</td>
<td>$2,456,017</td>
</tr>
<tr>
<td>Land Improvements</td>
<td>1,247,329.95</td>
<td>387,023.35</td>
<td>850,306.60</td>
<td>823,823.95</td>
</tr>
<tr>
<td>Railroad Sidings</td>
<td>317,163.33</td>
<td>619,043.04</td>
<td>235,252.29</td>
<td>235,252.29</td>
</tr>
<tr>
<td>Equipment and their Buildings and their Equipment</td>
<td>480,321.01</td>
<td>1,330,631.41</td>
<td>347,257.96</td>
<td>347,257.96</td>
</tr>
<tr>
<td>Machinery and Equipment</td>
<td>424,006.65</td>
<td>1,766,306.37</td>
<td>247,177.26</td>
<td>247,177.26</td>
</tr>
<tr>
<td>Engineering, Experimental and Laboratorial Equipment</td>
<td>107,615.15</td>
<td>261,900.75</td>
<td>616,24.40</td>
<td>616,24.40</td>
</tr>
<tr>
<td>Patterns, Dies, Jigs and Fixtures</td>
<td>845,614.13</td>
<td>645,614.13</td>
<td>1,500,028.26</td>
<td>1,500,028.26</td>
</tr>
<tr>
<td>Autos, Airplanes, Trucks and Tractors</td>
<td>102,707.69</td>
<td>44,040.77</td>
<td>58,030.32</td>
<td>58,030.32</td>
</tr>
<tr>
<td>Furniture &amp; Fixtures</td>
<td>243,361.58</td>
<td>53,499.18</td>
<td>149,862.40</td>
<td>149,862.40</td>
</tr>
<tr>
<td>Dwellings</td>
<td>116,140.03</td>
<td>770,1.19</td>
<td>789,531.44</td>
<td>789,531.44</td>
</tr>
<tr>
<td>Construction in Progress</td>
<td>356,954.97</td>
<td></td>
<td>356,954.97</td>
<td>356,954.97</td>
</tr>
<tr>
<td>Total</td>
<td>$1,115,524.75</td>
<td>$331,663.06</td>
<td>$7,823,794.79</td>
<td>$7,823,794.79</td>
</tr>
</tbody>
</table>

Capital Surplus:

Balance, November 30, 1930 $451,242.22
Deduct:
Amortization of Appreciation 26,900.61

---

1. 1931 Annual Report, Auburn Automobile Company.
Total Current Assets $30,932,334.11

OTHER ASSETS:
- Branch houses, service plants, leaseholds and Detroit property not presently used in manufacturing operations 13,491,083.71
- Less reserves for depreciation 2,733,282.03 10,757,801.68

Total Current Assets 5,983,676.57

CASH IN BANK - SPECIAL DEPOSITS (PER CONTRA) 468,400.00

DEPOSITS RECEIVED ON SECURITIES LOANED (PER CONTRA) 468,400.00

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1. "In 1920, '22 and '29, the corporation declared stock dividends equivalent to 826,268 shares of its present no par stock. These shares were capitalized at $33,051,520, or $40 per share. Common stock capital account was accordingly credited with this amount, and Surplus earnings ($49,037,267.27 as above) were charged the same amount. This action reduced the Surplus account on our books to $15,975,737.27 as of December 31, 1921, as shown by this report, including Special Surplus account of $6,100,000 which was established under charter requirements in respect to the purchase and retirement of preferred stock.

"In the judgment of your directors, this $33,051,520 should be transferred from the common stock capital account and returned to Surplus account where it would be available to use for carrying out the desire of the directors to write down the "Trade Name, Good Will and Patent Rights" account, which was created as a capital asset when the corporation was formed, from $19,607,276.64 to $1.00 and to write down the book value of its investments in plant facilities and for other purposes. The transfer of $33,051,520 from capital to surplus would leave the common capital $33.15 per share, instead of $40.00 per share as at present. Your directors believe it advisable that at the same time $3.15 per share additional should be transferred from capital to surplus to make the common capital, after such transfer, a round figure of $30.00 per share. No part of this transferred surplus might be used for dividends on the common stock as long as any of the preferred stock remained outstanding.

"If the write-down of plant facilities is made, substantial savings would result to the corporation in depreciation and other charges thereby benefiting the profits of future years. Last year our charges against profits for depreciation alone amounted to $2,261,566.46, or $38.95 per car produced." 1931 Annual Report, The Studebaker Corporation.

Note: Investments in Stocks of Affiliated Companies stated at $6,406,291.20 includes $5,418,111.20 of listed stocks, the market value of which was at November 30, 1931 was $9,304,230.90. Unlisted stocks amounting to $968,180 are valued below the book value of these stocks as shown by the books of the Affiliated Companies.

(The above was on the face of the balance sheet. The President's report says they had a book value of $2,092,000 and earnings applicable thereto of $463,000 for the period, no part of which has been taken up.)

Total fixed assets
IMPROVEMENTS TO LEASED PROPERTY, ETC.
LESS AMORTIZATION

Other Income:
Dividends Received--
In Stock, taken up at amounts capitalized by
issuing company
Bad Debt Recoveries

Current Assets:
Inventories at cost or market, whichever is lower --
Groceries
Premiums

Deferred Charges:
Premiums (at cost) advanced to customers
Less reserve for doubtful accounts

Investments:
Bonds of parent and Subsidiary companies held for
sinking funds

Add--Other Income
Dividend from Ore Company
Less-Portion thereof applied as amortization
of investment

1. 1931 Annual Report, Jewel Tea Co., Inc.
Total Current Assets

$96,510,261.28

OTHER ASSETS:

Securities - at cost 4,370,423.65
Less: Unpaid portion of subscription to Income Notes of the Credit Corporation of Akron -- Subject to call 1,000,000.00 3,370,423.65
Investments of Subsidiary Company, having an indicated value at October 31, 1931, of approximately $2,500,000.00 6,224,196.38

THE FIRESTONE PARK LAND COMPANY

House and Lot Accounts Receivable, Unsold
Real Estate, etc. 2,075,673.68
Less: Mortgages thereon and Accrued Interest 224,907.17 1,850,766.51

RESERVE

For Investments: created by crediting discount on Preferred Stock purchased for Treasury during year 1,860,164.67

CONSOLIDATED SURPLUS OCTOBER 31, 1930 41,984,248.99

ADDITIONS

Net Profit for year ending October 31, 1931--as shown by Income & Expense Statement 6,028,630.90
Increase in Insurance Account Surplus 106,824.14 6,135,455.04

DEDUCTIONS

Dividends Paid:
Preferred - 6% $3,371,904.00
Common-$1.00 per share 2,136,521.30 5,508,425.30
Provision of Reserve to reduce Employees' Stock Purchase Contracts to basis authorized by Board of Directors 3,004,650.00
Adjustment of Net Assets of Foreign Subsidiaries, exclusive of Permanent, to basis of exchange rates prevailing at October 31, 1931 $1,906,727.74
Deduct: Amount charged against Operating Results 99,366.66 1,609,361.06

2. Equity side of balance sheet.
Net adjustment of various accounts as of October 31, 1930, including inter-company profits in Inventories of Service Stores, not previously consolidated ....... $786,863.58
Net charge resulting from cancellation of Employees' Stock Contracts and reducing Treasury Common Stock to par value .... 629,245.60
CONSOLIDATED SURPLUS OCTOBER 31, 1931...

SUMMARIZED AS FOLLOWS:

- General Surplus ............... $31,416,106.50
- Surplus arising from issuance of Common Stock on present Employees' Stock Contracts 2,309,200.00
- Insurance Account Surplus ....... 2,655,649.97

CONSOLIDATED SURPLUS OCTOBER 31, 1931 $36,360,958.47

Contingent Liabilities Reported - None

Miscellaneous Investments and Advances:

- Investment in stock of The Commonwealth Alcorn Company, a wholly owned subsidiary not consolidated $150,000.00
  Note - The property owned by the Commonwealth Alcorn Company is subject to a mortgage in the amount of $250,000 payable January 30, 1935 to which the Hupp Motor Car Corporation is not a party.

Common Stock:

- Authorized - 4,000,000 Shares of no par value
- Issued - 1,167,142 Shares ............. $97,669,380.00
- Less--Exclusion of Intangible Capital Assets, namely, Goodwill, Patents and Trademarks, per contra ............... 57,796,001.00
- $39,873,379.00

Total Current Assets $13,075,503.06
PREPAID FREIGHT AND DUTY, ETC. 95,940.82

Current Assets:

Accounts Receivable:
- Regular terms, less reserves of $155,689.00: $3,587,573.05
- Installment terms, less reserves of 151,656.55

Fixed Assets:
- Land, and buildings on land owned and leased at 1929 appraised values less depreciation: $27,526,092.26

Mortgages Payable - $150,000 due annually on November 1, balance November 1, 1938, interest at 5 1/2 and 5%: $5,650,000.00

Balance of Surplus, Feb. 1, 1929: $9,525,602.65

Add:
- Net Profit for the year ended February 1, 1930 after deducting depreciation on increased values shown by appraisals: $1,502,821.00
- Depreciation on increased values shown by appraisals, transferred from property surplus: $226,757.35

Deduct:
- Expenses incurred in moving into new buildings: $150,630.36

Other Investments - at cost, and for controlled companies including proportion of profits or losses since acquisition: $305,446.94

Current Assets:
- Cash Surrender Value of Life Insurance: $43,517.19
- Notes and Accounts Receivable:
  - Customers: $1,174,598.84
  - Sundry Debtors: 105,782.37
  - Employees: 70,574.75
- Total: $1,350,956.96

1. 1930 Annual Report, L. Bamberger & Co.
3. 1931 Annual Report, United Biscuit Company.
(21-a Cont'd)

Less- Reserves for -
Discounts . . . . . . . $78,520.65
Doubtful Accounts . . 81,786.91 $160,309.56 $1,190,647.40
Inventories --
Raw Materials. . . . . . . $393,540.75
Finished and Process Stocks . . 614,934.16
Packages, Supplies, etc. . . . 453,964.75 1,462,429.66

(21-b)

RETURNABLE CONTAINERS, RACKS, ETC.
LAND, BUILDINGS, OVENS, MACHINERY AND
EQUIPMENT:
At book values . . . . . . . $10,881,350.25
Less-Reserves for Depreciation
and Obsolescence . . . . . . 4,116,128.75 6,765,221.50

(21-c)

OTHER ASSETS:
Balances in Closed Banks . . . . . . $38,601.70
Miscellaneous . . . . . . . . . 21,630.10 57,431.80

(21-d)

COST OF CAPITAL STOCKS OF SUBSIDIARY
COMPANIES in excess of Net Tangible
Assets acquired . . . . . . . . . 2,600,051.59

(21-e)

Deduct:1
Proportion of organization expenses,
etd., written off . . . . . . . . 28,575.42

(22-a)2

 Marketable Securities at Cost
Market Value
December 31, 1930 $12,278,115.55
February 25, 1931 $12,562,704.86

1. Profit and Loss Statement.
2. 1930 Annual Report, Wm. Wrigley Jr., Company.
Marketable Securities at Cost--

Stocks ........................................ \$6,138,616.83
(Market Value, December 31, 1931,
\$3,005,779.56)

Bonds:
U.S. Government Obligations ............. 1,366,316.00
Municipal ................................ 5,032,040.20
Industrial ................................ 3,635,110.25
Public Utility and Railroad ............. 921,377.02
Foreign Government ........................ 790,479.09

\$17,666,139.39

Total Assets .................................. \$10,322,655.19

EXCESS OF LIABILITIES OVER BOOK VALUE OF
ASSETS (Per statement attached) ............. 264,926.30

\$10,057,728.89

Work in Process (partly pledged per contra) \$ 343,773.93
Finished goods, grey and printed (pledged per contra) 364,547.34

Consolidated Selling Company, Inc.--
Current account (secured by finished goods and
work-in-process per contra) 226,210.64

CURRENT ASSETS

Cash ........................................... \$10,305,311.23
Bankers Acceptances, less unearned Discount 1,849,640.83
United States Treasury Bills, less unearned
Discount .................................. \$ 998,472.21
United States Government
Bonds, at Market .......................... 2,573,499.06
Canadian Government Bonds, at
Larket ..................................... 1,387,066.44
British Treasury Bills, at
Larket ..................................... 51,130.08
State and Municipal Bonds, at
Larket ..................................... 2,763,882.85
Other Marketable Bonds, at
Larket ..................................... 328,567.50 6,102,459.94
Accrued Interest Receivable ................ 135,707.34
Notes and Collateral Loans Receivable ..... 285,347.55
Accounts Receivable (Less Reserve, \$521,216.52) 5,042,516.95
Inventories, at lower of Cost or Market .. 12,995,738.76

TOTAL CURRENT ASSETS ...................... \$38,517,922.30

1. 1931 Annual Report, Wm. Wrigley, Jr., Company.
2. 1931 Annual Report, Consolidated Textile Corp.
### GENERAL INSURANCE FUND

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,185.91</td>
</tr>
<tr>
<td>United States Treasury Notes, at Market</td>
<td>2,768.38</td>
</tr>
<tr>
<td>United States Liberty Loan Bonds, at Market</td>
<td>317,925.00</td>
</tr>
<tr>
<td>State and Municipal Bonds, at Market</td>
<td>1,041,283.50</td>
</tr>
<tr>
<td>Accrued Interest Receivable</td>
<td>2,646.05</td>
</tr>
</tbody>
</table>

TOTAL GENERAL INSURANCE FUND: $1,365,809.84

### GENERAL INSURANCE FUND ACCOUNT -- Appropriated Surplus Set Aside to Meet Contingencies

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,365,809.84</td>
</tr>
</tbody>
</table>

### CURRENT ASSETS:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on hand, in transit and in bank</td>
<td>$10,504,278.34</td>
</tr>
<tr>
<td>Marketable securities at cost</td>
<td>$4,597,911.39</td>
</tr>
<tr>
<td>Less-Reserve to adjust to quoted market values at December 31, 1931</td>
<td>1,303,434.06</td>
</tr>
<tr>
<td></td>
<td>3,294,477.33</td>
</tr>
</tbody>
</table>

### Loss--before extraordinary items and adjustments below...

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shrinking foreign subsidiaries</td>
<td>$2,000,000.00</td>
</tr>
<tr>
<td>Special tools</td>
<td>2,000,000.00</td>
</tr>
<tr>
<td>Contingencies</td>
<td>500,000.00</td>
</tr>
<tr>
<td>Special Advertising</td>
<td>1,400,000.00</td>
</tr>
<tr>
<td>Rearrangement of plant equipment</td>
<td>632,706.94</td>
</tr>
<tr>
<td></td>
<td>6,532,706.94</td>
</tr>
</tbody>
</table>

### Total Current Liabilities

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3,589,606.29</td>
</tr>
</tbody>
</table>

### Reserve, special tools and other contingencies

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3,251,965.45</td>
</tr>
</tbody>
</table>

### Prepaid and Deferred Charges:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchange Fluctuations on Current Assets of Foreign Subsidiaries</td>
<td>$4,558,953.62</td>
</tr>
<tr>
<td>Other Prepaid and Deferred Charges</td>
<td>9,101,255.34</td>
</tr>
<tr>
<td></td>
<td>10,623,113.35</td>
</tr>
<tr>
<td></td>
<td>13,660,208.96</td>
</tr>
<tr>
<td></td>
<td>10,623,113.35</td>
</tr>
</tbody>
</table>

---

1. 1931 Annual Report, General Foods Corporation
2. 1931 Annual Report, Hudson Motor Car Company
### (27-b)

**SURPLUS:**  
- Capital Surplus Paid-In ......................... $46,148,196.46  
- Earned Surplus:  
  - Appropriated for Exchange Fluctuations on  
    - Current assets of Foreign Subsidiaries .... $4,656,963.62  
    - Unappropriated .................................. $98,059,613.35  
- B  
  - Surplus, December 31, 1930 ....................... $19,759,952.99  
  - Surplus adjustment restoring to cost of property and to earned surplus the depreciated value of existing additions to permanent plant property charged to reserves created out of earned surplus in prior years .......... $21,866,203.39  
  - Excess of par and stated value over cost of Preferred and Common stock in Treasury - Net ............................. 776,706.07  
  - Loss for year ended December 31, 1931 ............. $3,929,384.24  
  - Dividends-Preferred stock ........................ $2,619,586.00  
    - Common Stock .................................... $767,900.00  
    - $3,387,286.00  
    - $7,316,670.24  
    - $35,066,172.21  
  - Capital surplus applied as a reduction of the Property Acct ............................................ 14,426,998.25  
  - Surplus, December 31, 1931 ....................... $20,661,195.96  
  - Earned Surplus ..................................... $19,886,467.89  
  - Capital Surplus .................................. 776,706.07  

### (28-1)

**CONSOLIDATED SURPLUS ACCOUNT**  
For the Year Ended December 31, 1931

- Surplus--December 31, 1930 as per Annual Report ................ $4,787,586.33  
- Deduct:  
  - Net Adjustments to Surplus as of December 31, 1930 based on an examination by the Auditors duly appointed at the annual meeting, for contingencies and other reserves arising from the operations of previous years, and for assets omitted from the balance sheet ........................................ 1,577,091.26  
  - Adjusted Surplus at December 31, 1930 ....................... $3,210,295.07  
- Deduct:  
  - (a) Loss as adjusted for the year ended December 31, 1931, detailed above ........................................ $2,836,626.02  
  - (b) Adjustment of book value of active properties in accordance with report of Chas. T. Pain, Inc. July 1, 1931, to basis of approximate cost less accrued depreciation ........................................ 10,041,769.20  
  - (c) Book value of inactive plans, tenements and miscellaneous properties transferred to Textile Realty Company, a wholly owned subsidiary--written off ........................................ 7,416,627.29  
  - (d) Note Issue Expense of previous years and Premiums written off ........................................ 134,550.52  
  - (e) Net additions to Reserve for Contingencies- Rentals under leases of vacated premises 500,000.00  
  - (f) Amount written off Sundry Investments ........................ 19,001.25  
- Deficit--December 31, 1931 ...................................... $17,736,679.21

1. 1931 Annual Report, American Locomotive Company  
2. 1931 Annual Report, American Woolen Company, Inc.
Note: The Company has transferred to the Textile Realty Company at a book value of $7,416,827.29 its inactive plants, tenements and miscellaneous properties. No dividends have been paid on the 7% cumulative Preferred Stock since April 15, 1927. Contingent Liabilities: Pending Lawsuits, Leases of Vacated Premises and Purchase Commitments at not exceeding market prices.

Total Stock and Liabilities $90,535,397.37
Deficit after writing off properties transferred to Textile Realty Company and adjustment of other fixed assets $17,735,679.21
Deduct $72,796,718.16

Current Liabilities:
Purchase Money Obligations maturing serially within 12 months $2,253,455.32
Serial payments on investments due within 12 months 1,377,610.92

Total current liabilities $16,061,547.06
Purchase money obligations maturing serially after 1 year $7,480,935.48
Serial payments on investments due after 1 year 4,426,018.31
Mortgages and bonds of subsidiary companies, less $433,541.87 sinking fund payments (including $3,548,951.85 payable within one year $76,859,795.23
Twenty-year 6% Sinking Fund Gold Bonds 13,363,000.00
Twenty-year 5 1/2% Sinking Fund Gold Bonds 14,756,000.00 104,978,795.33

Contingent mortgage liability of subsidiary companies $1,946,357.06
Contingent liability on investment notes discounted 1,237,499.90

1. 1930 Annual Report, Paramount-Publix Corporation.
Reserve for foreign exchange
fluctuations ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... 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... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... ... (30-d)\(^1\)
Total
U.S.A.
Foreign

\[\begin{array}{ccc}
\text{Reserve for foreign exchange} & \$2,316,049.79 & \$2,316,049.79 \\
\text{Appropriated surplus and} & \$2,625,811.31 & 357,102.69 \\
\text{other reserves} & \text{Total liabilities} & \text{Investment and advances (net) eliminated} \\
\text{Total liabilities} & \$2,982,374.00 & \$23,170,222.27 \\
\text{Investment and advances (net) eliminated} & \text{(23,737,022.77)X 23,472,702.27} & \\
\end{array}\]

\[\text{\# The Capital Assets of all foreign subsidiary companies have been converted at the rates of exchange prevalent at dates of acquisition; all other assets and liabilities have been converted at current rates of exchange. The reduction in funded debt, arising from the conversion on this basis of the long term liabilities of the British and Canadian subsidiaries, has been carried to reserve.}\]

X Red.

(31-a)\(^2\)

\[\begin{array}{c}
\text{PROPERTIES:} \\
\text{Goodwill and Patents (Reduced by $411,607.45 being profit from disposition of Treasury Stock in 1921) $13,014,276.34} \\
\end{array}\]

(31-b)

\[\begin{array}{c}
\text{OTHER ASSETS AND DEFERRED CHARGES:} \\
\text{Land Sales Contract and Property not required for operating purposes $1,075,421.43} \\
\end{array}\]

(32-a)\(^3\)

\[\begin{array}{c}
\text{Cash Surrender Value-Life Insurance Policies $76,022.12} \\
\text{Total Current Assets $13,452,069.36} \\
\end{array}\]

(32-b)

\[\begin{array}{c}
\text{ALTERATIONS AND IMPROVEMENTS TO LEASED PROPERTIES $4,642,275.05} \\
\text{(This amount is being written off over a period not in excess of the term of the leases involved)} \\
\end{array}\]

(32-c)

\[\begin{array}{c}
\text{DEFERRED} \\
\text{Notes Payable - For Lease - Due 1933 to 1936 $137,500.00} \\
\text{Tenants Deposits as Security for Leases (Expanding 1933-1949) $24,091.67} \\
\end{array}\]

(32-d)\(^2\)

\[\begin{array}{c}
\text{Surplus (including $9,826,679.14 earned since formation of Delaware Company in 1927) $14,686,721.98} \\
\end{array}\]

(52-e)

\[\begin{array}{c}
\text{RESERVE FOR REPAINTING STORES 97,596.29} \\
\end{array}\]

1. 1931 Annual Report, Paramount Publix Corporation
2. 1931 Annual Report, Allis-Chalmers Mfg Co.
REVIEW QUESTIONS

1. What do you consider to be a satisfactory caption for the right-hand side of a balance sheet drawn up in account form? Why?
2. What constitutes WORKING FUNDS? How may they be presented on the balance sheet?
3. What are some important facts to be remembered in properly setting forth the accounts receivable?
4. What items are often erroneously entered on the balance sheet as Prepaid Assets?
5. What is the author's objection to the "popular" form of balance sheet (account form)?
6. Name 5 items that are Other Assets.
7. State 6 important facts bearing on the proper presentation of inventories.
8. Why should balance sheets ordinarily be prepared primarily for those interested in the current position of the company?
9. Analyze the balance sheet in section 629. Be prepared to answer questions thereon.
10. When does the item of cash have to be qualified? When is it a fixed asset?
11. What are "descriptive" balance sheets?
12. What are the important principles to be observed in setting forth the current notes payable?
13. Should the balance sheet list the collateral, if any, securing the notes receivable?
14. What problems of presentation often arise in connection with plant property?
15. To what extent should an auditor accede to the client's desire for a certain balance sheet presentation?
16. In your opinion which presentations in 627 are good? Poor? Why?
17. What is your opinion of the following?
   * Writers of text books on accounting speak of the purpose of the balance sheet as being to reflect the values of the assets and the liabilities on a particular date. They explain the fact that in many balance sheets certain assets are stated at figures which are obviously far above or far below true values by saying that the amounts at which such assets are stated represent "conventional" valuations. Such statements seem to involve a misconception of the nature of a balance sheet.
   * In an earlier age, when capital assets were inconsiderable and business units in general smaller and less complex than they are today, it was possible to value assets with comparative ease and accuracy and to measure the progress made from year to year by annual valuations. With the growing mechanization of industry, and with corporate organizations becoming constantly larger, more completely integrated and more complex, this has become increasingly impracticable. From an accounting standpoint, the distinguishing characteristic of business today is the extent to which expenditures are made in one period with the definite purpose and expectation that they shall be the means of producing profits in the future; and how such expenditures shall be dealt with in accounts is the central problem of financial accounting. How much of a given expenditure of the current or a past year shall be carried forward as an asset cannot possibly be determined by an exercise of judgment in the nature of a valuation. The task of appraisal would be too vast, and the variations in appraisal from year to year due to changes in
price levels or changes in the mental attitude of the appraisers would in many cases be so great as to reduce all other elements in the computations of the results of operations to relative insignificance.' -- A.I. of A.

16. What is your opinion of the following?

1. To bring about a better recognition by the investing public of the fact that the balance sheet of a large modern corporation does not and should not be expected to represent an attempt to show present values of the assets and liabilities of the corporation.

2. To emphasize the fact that balance sheets are necessarily to a large extent historical and conventional in character, and to encourage the adoption of revised forms of balance sheets which will disclose more clearly than at present on what basis assets of various kinds are stated (e.g. cost, reproduction cost less depreciation, estimated going-concern value, cost or market whichever is lower, liquidating value, etcetera).

3. To emphasize the cardinal importance of the income account, such importance being explained by the fact that the value of a business is dependent mainly on its earning capacity; and to take the position that an annual income account is unsatisfactory unless it is so framed as to constitute the best reflection reasonably obtainable of the earning capacity of the business under the conditions existing during the year to which it relates.'--A. I. of A.
CHAPTER 49

STATEMENTS OF PROFIT AND LOSS
(Form and Content)

§30. Unsettled Accounts.  §31. Cartons, etc.
§32. Distribution of Administrative Expense.  §33. Titles and Captions.
§35. Contents.  §36. "Verification of Financial Statements."
§37. Report Form and Account Form.  §38. Earnings before Bond Interest and/or Depreciation, and/or Federal Income Taxes.

Review Questions.

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§30. "Unsettled" Accounts.--In regard to the proper location in the profit and loss statement of such accounts as bad debt expense, freight on sales, patent expense, purchase discount, sales discount, partner's salaries, and the like, it may be said that leading authorities do not always agree. Thus one may find bad debt expense being treated either as a deduction from gross sales, or as an administrative expense, or as a selling expense, or as a financial expense. Since there is no decided weight of opinion, the auditor must recognize that his own individual preference should not override the client's preference. Indeed, the matter is largely, if not purely, an academic question of little moment to most business executives, even admitting the change it causes in certain percentage computations when the account is placed in the various locations. In short, with but rare exceptions these accounts should be placed in whatever position coincides with the client's opinion, for in that location they will be most useful to him for management purposes.

As to the auditor himself, he should undoubtedly have a definite opinion as to how these items should be treated according to correct theoretical analysis so that he can handle them properly, if given permission to do so.

§31. Cartons, etc.--If the finished product comes to the consumer in a container, such as the package in the case of cereals, the cost of the carton is a manufacturing expense -- not a selling expense. On the other hand, if the containers are of the type used for shipping purposes, such as those which may hold several dozen packages of cereal, the cost thereof is a selling or shipping expense. In most instances this difference of treatment is of no consequence whatever, but in some few businesses the method of handling the account may cause an appreciable difference in the value of the final inventories of finished goods, etc.

§32. Distribution of Administrative Expense.--In several prior sections of the text, it was pointed out that administrative expenses should not enter into the manufacturing overhead. A refinement of this position is now made at this point. If the auditor finds that the client's cost system is a highly developed one wherein the individual administrative items (service departments) are distributed in whole or in part on sound bases to the factory and to the selling department, he must realize that it is sound practice. This assumes, of course, that the sums distributed were incurred by the service department for the benefit of the factory and/or selling divisions; i.e., there will always be some administrative expenses that are not assignable (because they are 100% administrative items).

For example, if the cost department is actually located in the factory, the cost thereof will undoubtedly be recognized as a factory
overhead item. But if it is located in the administrative building and is not sharply differentiated as a separate department with its own head, etc., its estimated cost is not an administrative expense simply because of the difference in the physical location of the department, or from the fact that the department may be under the control of the general accountant. On the other hand, directors' fees are best handled as 100% administrative item, even though a factory or a selling problem or policy was decided upon during the course of the directors' meeting.

633. Titles and Captions.--As to the proper caption for the statement, such titles as Revenue Account, Income Account, Statement of Operations, Statement of Profit and Loss, etc., are to be found in current use. As long as the statement is drawn up on the basis of sound principles, wherein the operating income and expenses are kept separate so that the figure for the "Net Profit on Operations" is really what it purports to be, the selection of a suitable caption for the statement as a whole is largely inconsequential. It is doubtful if a USABLE title can be devised which will be EXACTLY correct.

634. Inventories.--Section 281 was devoted to the proposition that the reduction necessary to bring the final inventories to a cost or market, whichever the lower, basis, or to any other recognized sound basis, should be treated as a separate profit and loss (or surplus) item, for, if it were offset against the cost of the final inventories, the figures for the "Cost of Sales", and hence also for "Gross Profit", would be meaningless and incomparable from year to year.

As will be seen by referring to Appendix C, Sec. 17, the problem involved is recognized everywhere to be of vital importance to a correct analysis and presentation of operating results, but there is no unanimity of opinion as to how that can best be achieved.

635. Contents.1--When there is presented an ANALYSIS OF SURPLUS statement, or when there is a fully elaborated surplus section on the balance sheet, the contents of the PROFIT AND LOSS STATEMENT may satisfactorily be that ordinarily given; namely, (1) Sales division, (2) Cost of Goods Sold division, (3) Selling Expense division, (4) Administrative Expense division, (5) Financial Income division, and (6) Financial Expense division. (This list omits, of course, amplifications thereof wherein there is included special subdivisions adapted to the needs of a particular business or class of businesses, such as Buying Expense, Publicity Expense, Occupancy Expense, etc., in the case of department stores.) But when this is not the case, there should be added, after the NET PROFIT has been ascertained (as per the ordinary profit and loss statement), two divisions: one entitled, NON-OPERATING GAIN AND INCOME (e.g.--Gains on Sales of Capital Assets, Excess of Insurance Recoveries over Bookvalues, Payments Received from Lawsuits, etc.); and one entitled, NON-OPERATING LOSS AND EXPENSE (e.g.--Special Strike Protection Expense, Reduction of Inventories to Cost or Market, Fire Loss, Special Anniversary Celebration Expense, etc.). Furthermore, the results ascertained at this point should be added to the surplus at the beginning of the period, and thereafter further adjusted by any surplus charges or credits, so that the final balance of the profit and loss statement will be that stated on the balance sheet.2

1. See Appendix C, Sec. 15-4, 5, 6, and 7.
2. This assumes to repeat that there is no ANALYSIS of SURPLUS statement and that the SURPLUS is stated in a single figure on the balance sheet.
As can be seen, items falling within the above two additional divisions of the profit and loss statement are either current income and expense extraneous to the main lines of the business activity, or are current losses and gains which are extraneous but which, nevertheless, occur more or less regularly in a business of any size. Col. Montgomery states the former case thus: "Extraordinary expenses and losses occur in the best managed businesses. Under good management mistakes do not recur, but others follow which also are extraordinary. When mistakes of the past are eliminated and it is assumed that no mistakes will be made in the future, the managers are being set an impossible task." 1

On the other hand, those items which are properly entered direct into Surplus should be corrections of the prior period, distributions of dividends, appropriations to surplus reserves, and the like.

In short, although there is a difference of opinion as to the contents of a profit and loss statement, there is a decided weight of opinion that all of the changes between the surplus as at the beginning of the period and as at the end of the period must be presented in some way. The question of the particular contents of the Profit and Loss Statement, the Surplus section of the Balance sheet, and the Analysis of Surplus is secondary, 2 at least to accountants but probably not to the general public.

The following descriptions of the proper contents of a profit and loss statement are from recognized authorities:

"1. Sales:
Gross revenue from sales of service or product, less returns, allowances, cash discounts, and similar adjustments. This section concludes with the figure, total net sales.

2. Cost of Goods Sold:
All costs incurred until the product is available for sale. Includes all production costs in a manufacturing industry and all merchandise costs (usually including buying expenses) in a mercantile enterprise. This section concludes with the figure, cost of goods sold, which, if deducted alone from the concluding figure of section 1, yields margin on sales, often labeled "gross profit," or "trading income."

3. Operating Expenses:
All charges of conducting the enterprise as an economic unit other than those included in section 2 and applicable to obtaining the principal current revenue shown in Section 1. This section concludes with the figure, total operating expense, which, when deducted from margin on sales or when deducted together with the cost of goods sold from total net sales, gives the figure, operating income or net operating revenue.

4. Other Current Income:
Net income from minor activities and so-called financial management income, primarily interest and dividends. The total of this section should be added to operating income to give total net income, often termed "gross income."

1. Montgomery, p. 469.

2. There seems to be a distinct trend toward making the Profit & Loss Statement all-inclusive. Thus Montgomery (p. 362) says, "No changes should appear in the surplus account except charges for dividends and deficits, and no credits except credits for net income." See also appendix C, sec. 24-524.
5. Other Current Charges:
   Net losses from minor activities and so-called financial management expense, primarily interest on current liabilities. The balance at this point represents the net earnings on long-term capital invested, proprietary and otherwise, subject to deduction for income taxes.

6. Deductions from Income:
   Federal and state income taxes, bond interest (adjusted by amortization of bond discount or premium), and interest on other fixed liabilities. The items may be deducted consecutively or as a total to yield the figure for net proprietary income available for dividends or simply "net income."

7. Distribution of Net Profit:
   In corporations net income may be shown as carried directly to surplus, but is preferable set up against current dividend requirements, so that the amount carried to surplus (or the deficiency, as the case may be) is clearly shown. In single-proprietorships and partnerships net income is shown as an adjustment of either personal or capital accounts and is distributed as drawings."--Paton.

INCOME SHEET PRACTICE — SUMMARY

"A review of the annual reports of representative companies shows their profit and loss statements to have these features among others:

1. Results are stated comparatively with those of the prior year, at least.
2. Terms and items are defined and explained.
3. All income or sales are reported with proper separation for operating income or sales, preferably classified, from miscellaneous income, extraordinary or non-recurring income applicable to other years.
4. Cost of sales is shown for manufacturing and merchandising companies.
5. All expenses are deducted, a distinction being made between operating expenses, miscellaneous expenses, extraordinary expenses or expenses chargeable against other years.
6. Expenses are itemized reasonably with depreciation, interest charges, taxes, and general selling and administrative expenses, at least, separately shown."--M.L.I.Co.
<table>
<thead>
<tr>
<th>EXAMPLES</th>
<th>Net Sales</th>
<th>Deduct-Cost of Sales</th>
<th>Gross Profit</th>
<th>Deduct-Selling Expense</th>
<th>Net Profit on Sales</th>
<th>Deduct-Administrative Expense</th>
<th>Net Profit on Operations</th>
<th>Add-Financial Income</th>
<th>Gross Income</th>
<th>Deduct-Financial Expense</th>
<th>Net Profit to Surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td></td>
<td>$xx</td>
<td></td>
<td></td>
<td>$xx</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$xx</td>
</tr>
</tbody>
</table>

(b)  
(Same as above)  
Net Profit  
Add-Non-Operating Gains and Income  
Total  
Deduct-Non-Operating Losses and Expense  
Net Balance to Surplus  

(c)  
(Same as above in (a))  
Net Profit  
Extraordinary Gains and Income  
Surplus as at January 1  
Total  
Deduct-Extraordinary Losses and Expense  
Total Surplus Available  
Deduct-Dividends  
Balance, Surplus, December 31  

636. "Verification of financial statements." In order to certify the profit-and-loss statement for a given period the auditor must make such verification of the transactions during the period as will justify him in doing so. The extent of the verification will be determined by the conditions in each concern. In some cases he may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In others, where the system of internal check is good, tests only may suffice. The responsibility for the extent of the work required must be assumed by the auditor.

1. Condensed.
2. See Federal Reserve Board form in Section 836.
"114. The statement should be prepared as indicated in the following paragraphs, so as to reveal the operating results for the period under review. Corresponding figures for one or more years prior to the period under review should be obtained from the books for purposes of comparison. These comparative figures will furnish valuable information to the auditor and to the banker who is asked to grant credit to the company. If unverified amounts are included in the comparison, that fact should be clearly stated.

"115. A satisfactory form of profit-and-loss statement accompanies these instructions, but any other form giving generally similar information is acceptable. The following suggestions, however, must not be regarded as a program for verification of the profit-and-loss statement.

"116. Whenever it is possible, the quantities of merchandise sold should be reconciled with the inventory on hand at the beginning of the period, plus the production or purchases during the period, less the inventory on hand at end of the period.

"117. Where a good cost and accounting system is in force the sales records probably will be well kept, but the auditor should satisfy himself, by reference to the shipping records, that the sales books were closed on the last day of the period and that no goods shipped after that date are included in the record of the period. When an examination is being made for the first time, the auditor should make sure that the sales at the beginning of the period were recorded in accordance with the dates of shipment. This can be done by comparing the shipping memoranda with the invoices.

"118. Allowances to customers for trade discounts, outward freights, reductions in price, etc., should be deducted from gross sales in the profit-and-loss statement.

"119. The unfilled orders at the close of the year should be ascertained for comparison with the record of orders on hand at the corresponding dates of other years which will furnish an indication of the concern's condition and prospects. The auditor should give consideration to the concern's ability or inability to meet its sales-contract obligations.

"120. The inventory at the beginning of the period, plus purchases or cost of goods produced during the period, less the inventory at the end of the period, indicates the cost of sales. The auditor must be careful to see that cost of sales does not include charges which should have been classified otherwise. Interdepartmental profits should be eliminated. Any intercompany relationships giving rise to profits or losses should be borne in mind when determining the cost of sales.

"121. Gross profit on sales is ascertained by deducting cost of sales from net sales. The ratio of gross profits to net sales should be computed and compared with like ratios of previous years.

"122. Selling, general, and administrative expenses, particularly the larger items, should be examined to ascertain that the amounts are proper charges to these accounts and that the credits do not arise from disposition of capital assets. Selling, general, and administrative expenses should be classified in the profit-and-loss statement so as to display the important features of each class. Expenses which do not fall into any of these three classes should appear separately on the statement.
"123. Net profit on sales is ascertained by deducting the aggregate of selling, general, and administrative expenses from gross profit on sales. The ratio of net profit to sales should be computed and compared with similar ratios of previous years.

"124. Income derived from sources other than sales, such as income from investments, interest, discounts, etc., should appear under the heading, 'Other Income.' A schedule for each class of income should be prepared, and the auditor should assure himself of the propriety of including each item as income.

"125. 'Other Income' and 'Net Profit on Sales' constitute gross income.

"126. Interest on bonded debt, interest on notes payable, taxes, depreciation for which no other provision is made, etc., should appear under the heading, 'Deductions from Income.' Appropriate schedules should be prepared and the auditor should see that the entries are justified.

"127. Gross income less the deductions from income constitute the net income for the period.

"128. Items of unusual profit or loss which are not the result of ordinary transactions of the concern and items which are due to operations of prior periods should be shown as special credits or special charges to profit and loss.

"129. The profit and loss for the period is the result of adding special credits to and deducting special charges from net income for the period.

"130. Surplus is the result of adding or deducting profit or loss for the period to or from the surplus at the beginning of the period and deducting paid or declared and other appropriations."

**FORM OF PROFIT-AND-LOSS STATEMENT**

| Gross Sales | .................................................. |
| Less outward freight, allowances and returns | .................................................. |
| Net sales | .................................................. |
| Inventory beginning of year | .................................................. |
| Purchases, net (or cost of goods produced and sold) | .................................................. |
| Less inventory end of year | .................................................. |
| Cost of sales | .................................................. |
| Gross profit on sales | .................................................. |
| Selling expenses (itemized to correspond with ledger accounts kept) | .................................................. |
| Total selling expenses | .................................................. |
| General expenses (itemized to correspond with ledger accounts kept) | .................................................. |
| Total general expenses | .................................................. |
| Administrative expenses (itemized to correspond with ledger accounts kept) | .................................................. |
| Total administrative expenses | .................................................. |
| Total expenses | .................................................. |
| Net profit on sales | .................................................. |
Other income:

- Income from investments.
- Interest on notes receivable, etc.
- Gross income.

Deductions from income:

- Interest on bonded debt.
- Interest on notes payable.
- Taxes, depreciation, etc. (separately shown).
- Total deductions.

Net income for the period.

Add special credits to profit and loss (separately shown).

Deduct special charges to profit and loss (separately shown).

Profit and loss for period.

Surplus beginning of period.

Add or deduct items in the surplus account attributed to prior periods.

Dividends paid.

Earned surplus at end of period.

If a profit-and-loss statement is prepared for more than one year it should be set up in comparative form.

637. Report Form and Account Form.—There are two principal forms of profit and loss statements known as the report form and the account form. The report form is the one ordinarily used (see second statement below), since it is the easier to understand. The account form, so called because it has a debit and credit side to it, is rarely ever used. It is illustrated immediately below.

MIAMI COPPER COMPANY

Operating Account — Year Ended December 31, 1930

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31 to Development Mining and Milling Expenses</td>
<td>$4,242,471.09</td>
<td>By Operating Revenue</td>
<td>$8,425,631.77</td>
</tr>
<tr>
<td>To General Expense at Mine Taxes</td>
<td>$434,535.14</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>$417,736.93</td>
<td>Taxe on Other</td>
<td>$652,069.07</td>
</tr>
<tr>
<td>Freight, Smelting, Refining and Selling</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenses</td>
<td>$1,968,001.90</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Administration and Legal Expenses</td>
<td>$219,402.38</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating Profit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carried Down</td>
<td>$1,123,687.33</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$8,425,631.77</td>
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<td></td>
</tr>
<tr>
<td>Profit and Loss Account — Year Ended December 31, 1930</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1930

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
<th>Item</th>
<th>Amount</th>
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</thead>
<tbody>
<tr>
<td>Dec. 31 To Depreciation Charged Off During Year</td>
<td>$543,045.35</td>
<td>Dec. 31 By Operating Profit Brought Down</td>
<td>$1,123,687.33</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&quot; Profit Carried to Balance Sheet</td>
<td>$726,712.77</td>
<td>&quot; Interest</td>
<td>$37,279.79</td>
</tr>
<tr>
<td></td>
<td></td>
<td>&quot; Dividends</td>
<td>$108,791.00</td>
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<tr>
<td></td>
<td>$1,269,758.12</td>
<td></td>
<td>$1,269,758.12</td>
</tr>
</tbody>
</table>
A report form used by a national firm of certified public accountants.

STATEMENT OF INCOME AND PROFIT & LOSS
FOR THE PERIOD FROM (DATE) TO (DATE)

GROSS SALES ............................................. XXX
Less: Returns and Allowances .................. XXX
NET SALES .............................................. XXX
COST OF GOODS SOLD, Schedule #1 ............ XXX
GROSS PROFIT ........................................... XXX
SELLING, ADMINISTRATIVE AND GENERAL EXPENSES:
 Selling: (Give details) ......................... XXX XXX
 Administrative and General (Give details) .... XXX XXX
 Total ................................................... XXX

NET INCOME FROM OPERATIONS..................... XXX
OTHER INCOME :
 Interest ............................................... XXX
 Cash Discount on Purchases ................... XXX
 Income on Investments ......................... XXX
 Royalties ............................................... XXX
 Proportion of Bond Premiums .................. XXX
 Other Additions to Net Income from Operations. XXX
 GROSS INCOME .......................................... XXX
 DEDUCTIONS FROM INCOME:
 Interest on Funded Debt ....................... XXX
 Interest on Collateral Notes .................. XXX
 Interest on Long Term Notes .................. XXX
 Interest on Notes Payable ..................... XXX
 Cash Discounts on Sales ....................... XXX
 Federal and State Taxes ....................... XXX
 Loss or Inventories arising from adjustment to market values .. XXX
 Depreciation of Charged Against Income .... XXX
 Provision for Doubtful Notes & Accounts Receivable . XXX
 Proportion of Bond Discount and Expenses . XXX
 Proportion of Patent Rights Charged Off ...... XXX
 Other Charges Against Net Income from Operations. XXX XXX
 NET INCOME FOR THE PERIOD ..................... XXX

PROFIT AND LOSS CREDITS:
 Profit and Loss -- Surplus at Beginning of Period . XXX
 Profit on Bonds Purchased ...................... XXX
 Adjustment of Appraised Value of Property and Plant. XXX
 Other Credits Applicable to the Earnings of Prior Periods (if important) .... XXX
 GROSS SURPLUS ......................................... XXX

PROFIT AND LOSS CHARGES:
 Dividends on Preferred Capital Stock .......... XXX
 Dividends on Common Capital Stock .......... XXX
 Depreciation of Investments .................... XXX
 Other Charges which are deductible from the Earnings of Prior Periods . XXX
 PROFIT AND LOSS - SURPLUS ...................... XXX

EXHIBIT "B"

(This statement is submitted for discussion -- NOT as a model)
838. Earnings before Bond Interest, and/or Depreciation, and/or Federal Income Taxes.—Many profit and loss statements can be found which are deceptive in that they are terminated before the bond interest and/or the depreciation, etc. is deducted. It is fully recognized that for certain purposes, such as when a bond issue is being floated, it is advisable to state the profit before the bond interest has been deducted, so that the investing public can readily visualize the number of times which the profit at that point exceeds the interest requirements. In short, no objection can be legitimately offered to such presentations, provided the figure is clearly labelled "NET PROFIT BEFORE BOND INTEREST," and provided the current period's bond interest is then deducted.

In regard to federal income taxes, it is recognized that a critical analysis of this item will show it to be a DISTRIBUTION of profits and NOT an expense. On this basis it is a charge to SURPLUS. Nevertheless, as many business men look upon this tax in the same light as the local tax expense, it should be deducted before the business NET PROFIT is stated. The corporation MUST pay this tax, whereas other "distributions", such as dividends, are usually optional.

During periods of major price changes, such as during the 1930-34 depression, it is often advisable to show the net profit before deducting the charges for depreciation, provided the plant assets have not been currently revalued.

When such a presentation is made, it must be clearly labelled "NET PROFIT BEFORE DEPRECIATION" and the depreciation charges must then be deducted.

REVIEW QUESTIONS

1. What caption do you favor for statements of profit and loss? Why?
2. What is the proper contents of a Profit and Loss Statement?
3. What is the author's position with respect to the treatment of federal income taxes? Why?
4. What items are properly included under NON-OPERATING LOSS AND EXPENSE?
5. What should be the auditor's attitude in respect to the location in the Profit and Loss Statement of such items as Bad Debt Expenses, Sales Discount, etc.?
6. What items are properly included under NON-OPERATING GAINS AND INCOME?
7. May administrative expenses be included in the factory overhead?
8. What is the conflict between the basis of valuing an inventory for the balance sheet and for the profit and loss statement?
9. Is the cost of cartons, containers, etc., a selling expense or a manufacturing expense? When may this distinction be important?
10. What is your opinion of the following: "Within quite wide limits, it is relatively unimportant to the investor what precise rules or conventions are adopted by a corporation in reporting its earnings if he knows what method is being followed and is assured that it is followed consistently from year to year. Reverting to the illustrations already used, the investor would not need to be greatly concerned whether the straight-line or the sinking-fund method of providing for depreciation were being employed by a given corporation, providing he knew which method was being used and know that it was being applied in the same way every year. But if depreciation is charged in one year on the straight-line basis applied to cost and in another is charged on a sinking-fund basis applied to a valuation less than cost, the investor may be grossly deceived unless the change is brought to his notice. For this reason, the requirement of the Exchange that the depreciation policy of a company applying for listing shall be stated in the application is valuable, and it might well be amplified to include an undertaking to report to the Exchange and to stockholders any change of policy or any material change in the manner of its application."—A.I. of A.