Examination of Financial Statements

by

INDEPENDENT PUBLIC ACCOUNTANTS

A revision of the Bulletin prepared by the American Institute of Accountants in 1929 and published by the Federal Reserve Board under the title "Verification of Financial Statements"

Prepared and published
by the
AMERICAN INSTITUTE OF ACCOUNTANTS
January, 1936

ADDITIONAL COPIES

OF THIS BULLETIN MAY BE OBTAINED

FROM THE

AMERICAN INSTITUTE OF ACCOUNTANTS

13 East 41st Street, New York

AT

15 CENTS PER COPY

CONTENTS

PREFACE

Developments of accounting practice during recent years have been in the direction of increased emphasis on accounting principles and consistency in their application, and of fuller disclosure of the basis on which the accounts are stated. These developments have been accelerated by the prominence given to such matters in regulations of the Securities and Exchange Commission dealing with financial statements and also in correspondence during the years 1932 to 1934 between the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange.

The American Institute of Accountants considered that it was desirable to revise the bulletin which was prepared by the Institute in 1929 and published by the Federal Reserve Board under the title "Verification of Financial Statements", and has approved the work of a special committee in preparing this bulletin to replace the previous one. The suggestions contained in this bulletin are intended to apply to examinations by independent public accountants of financial statements prepared for credit purposes or for annual reports to stockholders.

In order to make the bulletin available to members of the Institute as promptly as possible, the Executive Committee has directed that it be printed and distributed.

January, 1936.

Examination of Financial Statements by Independent Public Accountants

SECTION I

General

This pamphlet deals with the accountant's examination of the balance sheet of a business enterprise at a specified date and of the profit and loss and surplus accounts for the period under review, and also with his review of the accounting procedure for the purpose of ascertaining the accounting principles followed and the adequacy of the system of internal check and control.

NATURE OF FINANCIAL STATEMENTS

Financial statements are prepared for the purpose of presenting a periodical review or report on progress by the management and deal with the status of the investment in the business and the results achieved during the period under review. They reflect a combination of recorded facts, accounting conventions and personal judgments; and the judgments and conventions applied affect them materially. The soundness of the judgments necessarily depends on the competence and integrity of those who make them and on their adherence to generally accepted accounting principles and conventions. It is for this reason, even more than for a check of the clerical accuracy, that an independent review of the statements is desirable.

In an earlier age, when capital assets were inconsiderable and business units generally smaller and less complex than they are today, it was possible for a merchant to value his assets annually with comparative ease and accuracy and in this way to measure the progress made from year to year. With the growing mechanization of industry, and with corporate organizations becoming constantly larger and more complex, this has become increasingly impracticable. From an accounting viewpoint, the distinguishing characteristic of business today is the extent to which expenditures are made in one period with the definite purpose or expectation that they shall be the means of producing profits in the future. How such expenditures shall be treated in accounts is the central problem of financial accounting. How much of a particular expenditure of the current or a past year shall be carried forward as an asset can not possibly be determined by a process of 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, in many cases would be so great as to reduce to relative insignificance all other elements in the computations of the results of operations. Consideration of the accounts of a business enterprise must start from the premise that an annual valuation of all the assets is neither practicable nor desirable for a going concern using its property only for production purposes.

Some method, however, has to be found by which the proportion of a particular expenditure to be charged against the operations of a given year and the proportion to be carried forward may be determined; otherwise it would be impossible to present an annual income account. Out of this necessity has grown up a body of conventions, based on a combination of theoretical and practical considerations, which form the basis for the determination of income and the preparation of balance sheets.

One of the important accounting conventions is that the balance sheet of a going concern shall be prepared on the assumption that the concern will continue in business. Plant assets, permanent investments and intangibles are usually stated at cost or on some other historical basis without regard to present realizable or replacement value. Assets such as inventories and accounts receivable are commonly stated at their going-concern value, which is usually greater than the realizable value in forced liquidation. Certain assets only, notably cash and readily marketable securities, are customarily stated at values which do not depend upon continuance of the business. In sharp contrast are the nominal assets, such as unamortized discount, the value of which might entirely disappear if the concern were to go out of business.

ACCOUNTING PRINCIPLES

While there is general agreement on certain broad principles, there remains room for differences in the application of those principles which may affect the results reached in an important degree. It is a generally accepted principle, for example, that the investment in an industrial plant should be charged against operations over the useful life of the plant; but there are several generally accepted methods of achieving this result. Among the methods used are the straight-line method, the sinking-fund method, the combined maintenance-and-depreciation method and the diminishing-balance method. The charges against a particular year may vary materially, depending on which method is employed.

Again, the most commonly accepted formula for stating inventories is at cost or market, whichever is lower; but different results may be obtained, according to the manner in which it is applied. For instance, cost of goods on hand may be determined on the theory that the first goods in are the first goods to go out, or that the last goods in are the first goods to go out. Cost might vary markedly under these alternative methods.

CONSISTENCY IN APPLICATION OF ACCOUNTING PRINCIPLES

Within certain limits it is less important what precise rules and methods are adopted by a corporation in reporting its earnings than that accepted principles shall be followed and followed consistently.

Reverting to the illustrations already used, a stockholder or creditor would not need to be greatly concerned whether the straight-line or the sinking-fund method of providing for depreciation was being employed by a corporation, provided he knew that an accepted method was being used and that it was being applied in the same way from year to year. But if depreciation is charged in one year on the straight-line method applied to cost and in another is charged on a sinking-fund method applied to a valuation less than cost, the financial statements may be misleading unless the change is clearly indicated.

Again it may not be a matter of great importance whether cost of goods on hand is determined on the theory that the first goods in are the first goods to go out, or that the last goods in are the first goods to go out. But it is important that the reader of the statements be advised of the inconsistency if one method is applied at the beginning of the year and the other method at the close of the year and the change makes any material difference in the results reported.

IMPORTANCE OF INCOME ACCOUNT

Financial statements as a general rule are prepared for three main purposes: for reports to management, for reports to stockholders and for credit purposes. Statements prepared for management purposes will usually contain considerable information of a statistical or detailed nature. Statements prepared primarily for the purpose of reporting to stockholders and other investors should not differ greatly from those prepared for bank and commercial credit purposes, though they may differ considerably from statements prepared for a prospectus which is essentially a selling document furnished for the information of prospective purchasers. As a rule a creditor is more particularly interested in the liquidity of a business enterprise and the nature and adequacy of its working capital; hence the details of the current assets and current liabilities are to him of relatively more importance than details of the long-term assets and liabilities. He also has a real interest in the earnings, because the ability to repay a loan may be dependent upon the profits of the enterprise. From an investor's point of view, it is generally recognized today that earning capacity is of vital importance and that the income account is at least as important as the balance sheet.

The development of accounting conventions has been influenced largely by a recognition of the importance of the income account. As a rule, the first objective has been to secure a proper charge or credit to the income account for the year, and in general the presumption has been that once this is achieved the residual amount of the expenditure or the receipt can properly find its place in the balance sheet at the close of the period. Thus the changes in the balance sheet from year to year are in many respects more significant than the balance sheets themselves.

It is also recognized that earnings of an enterprise for a single year, and still more so for shorter periods, are of limited significance, because they may be disproportionately affected by transitory influences. Fair conclusions as to earning power can not be drawn without comparison of the profits over a period of years and consideration of a number of other factors which can not be set forth in financial statements. Among these factors are the ability of the management and the effect of changes in technical processes, shifting markets, tariffs and taxation, on the plant, product and sales of the business. Any one of these human or physical or economic factors may throw the concern into difficulties or materially alter its financial condition and earning capacity.

BASIS OF STATING THE ACCOUNTS

It is an important part of the accountant's duty, in making his examination of financial statements, to satisfy himself that accounting practices are being followed which have substantial recognition by the accounting profession. This does not necessarily mean that all companies will observe similar or equally conservative practices. Accounts must necessarily be largely expressions of judgment, and the primary responsibility for forming these judgments and preparing the financial statements in which they are reflected must rest on the management of the corporation. But unless the difference is of minor importance the accountant must assume the duty of expressing his dissent through a qualification in his report or otherwise, if the conclusions reached by the management are, in his opinion, manifestly unsound, though he is not entitled to substitute his judgment for that of the management when the management's judgment has reasonable support and is made in good faith.

In view of the increased recognition of the importance of accounting principles and of consistency in their application, management is giving increasing attention to such matters and to the determination, where alternative methods are permissible, of the method to be adopted; and boards of directors are coming to regard this as one of their important responsibilities. The best practice in presenting financial statements is to indicate therein the bases on which the more important items are set forth. For example, it is desirable to disclose on what basis the inventory has been determined; the basis of stating the amounts shown for property, plant and equipment, investments, etc.; whether income on instalment sales is taken into account when the sale is made or as collected; and other matters which are of major importance in the business under review. Further, if there has been any change as compared with the preceding period, either in accounting principles or in the manner of their application, which has had a material effect on the statements, the nature of the change should be indicated.

CONSOLIDATED STATEMENTS

It has been rather generally accepted that the position and earnings of a parent company and its subsidiaries as a whole usually can best be presented by means of consolidated statements showing the combined position and operations of the group. There are certain general considerations affecting the preparation of such statements which are worthy of note.

Control of the subsidiary companies is an important prerequisite to the presentation of consolidated statements. The parent company should be in possession, directly or indirectly, of the power to direct, or to cause the direction of, the management and policies of the subsidiaries consolidated. Thus a company of which less than 50% of the voting stock is owned should ordinarily not be included in the consolidation. The general rule is that, when power to control is present, that principle of inclusion or exclusion the succeeding paragraphs. Many of the procedures suggested will apply in most cases but there are few cases where all of them will be used. The particular program chosen is intended for an examination, made for a report to stockholders or for bank-credit purposes, of the statements of a small or moderate-sized manufacturing or merchandising concern which has a reasonable system of internal check and control.

The scope of the examination and the extent of the detailed checking must be determined by the independent public accountant in the light of the conditions in each individual company. If there is little or no system of internal check, the client should be advised that a more detailed examination than that outlined hereafter is necessary if an unqualified report is to be furnished. If there is an adequate system of internal check, certain parts of the detailed procedure may be unnecessary.

For the sake of simplicity, the procedure suggested is submitted in the form of an audit program with such comments as seem called for on matters of principle. The procedure will not necessarily disclose defalcations nor every understatement of assets concealed in the records of operating transactions, or by manipulation of the accounts. Suggestions are made in the program as to the extent of information which should be given in the financial statements. While the final determination of this question rests with the company whose statements are the subject of examination, the accountant should use his influence to bring about adequate disclosure. If there is failure to disclose information which he believes to be material in the circumstances, his recourse is to comment on the matter in his report.

It should be understood that all of the work outlined need not necessarily be done as of the closing date of the period covered by the examination. It is frequently desirable to do the detailed work on the inventories or receivables as of an earlier date and, where conditions warrant it, this is satisfactory.

GENERAL

1. The accountant should determine (a) whether accepted accounting practices have been followed during the period under examination and (b) whether they have been changed in any material respect since the previous period. If the accountant is not satisfied in either respect and the amounts involved are material, reference thereto should be made in his report.

2. Compare the trial balances with the general ledger at the beginning and end of the period. Trace the items in the trial

by independent public accountants. While it is impracticable to set forth in any single program procedures which will fit the widely varying situations which will be encountered, the value of a detailed program as a guide is so generally recognized that one is given in Section II. The particular program chosen is intended for a small or moderate-sized manufacturing or merchandising concern. In Section III an indication is given of the nature of the modifications which will ordinarily be made in the case of a large-sized company with a more extensive organization and, consequently, a greater degree of internal check and control, and also in the case of small companies with inadequate internal control. Suggested forms of financial statements and of the report in which the accountant expresses his opinion of the financial statements (also referred to as his "certificate"), are given in Section IV.

SECTION II.

Outline of Examination of Financial Statements of a Small or Moderate-sized Company

In determining the nature and extent of his examination the accountant will necessarily take into consideration, among other things, (a) the purpose of the examination, (b) the amount of detail included in the statements to be covered by his report, (c) the type of business the accounts of which are to be examined, and (d) the system of internal check and control.

While the accountant is not in a position to control the use to which his report may be put, his program will necessarily be affected by the primary purpose of the examination and by any special instructions extending its scope. For example, if the principal purpose is to disclose possible irregularities, special investigation will be made of those accounts which are likely to be affected by such irregularities.

The amount of detail included in statements to be covered by the accountant's report will naturally affect the extent of the examination he will make to satisfy himself as to the substantial accuracy of the details given. This will apply particularly to the details of the profit and loss account; a statement which shows an analysis of the cost of sales or of the selling, general and administrative expenses will necessitate a closer review than would be required were a more condensed statement to be furnished.

The factors which are of major importance from the viewpoint of the independent public accountant vary widely in different classes of business and he will, of course, adapt his program to fit the particular circumstances. In a manufacturing or trading business, for instance, inventories are of relatively great importance in both the balance sheet and the statement of income; in an investment trust the confirmation of investment securities and the income therefrom are of prime importance; while in a public utility, questions involving the fixed assets, funded debt, plant additions, maintenance and fixed charges require particular attention.

An important factor to be considered by an accountant in formulating his program is the nature and extent of the internal check and control in the organization under examination. The more extensive a company's system of accounting and internal control the less extensive will be the detailed checking necessary. For example, a plant addition in a large-sized company may be limited to the amount of a specific appropriation made by the administration; the work may be undertaken by a construction department, the funds be disbursed by the treasurer's department and the whole be subject to review in the controller's department when the necessary entries are made. In such a case the accountant is obviously warranted in making a much less extensive check of the details than in a small company where the manager orders the expenditure and the bookkeeper makes the entries.

The term "internal check and control" is used to describe those measures and methods adopted within the organization itself to safeguard the cash and other assets of the company as well as to check the clerical accuracy of the bookkeeping. The safeguards will cover such matters as the handling of incoming mail and remittances, the proceeds of cash sales, the preparation and payment of payrolls and the disbursement of funds generally, and the receipt and shipment of goods. These safeguards will frequently take the form of a definite segregation of duties or the utilization of mechanical devices. For example, the cashier will have no part in the entering of customers' accounts or the preparation of their statements, and neither he nor the ledger keeper will have authority to issue or approve credits to customers; the clerk recording the labor time and preparing the payroll will not be permitted to handle the funds; approval and entry of vouchers will be made by others than the disbursing officer; and stock records and inventory control will be kept independent of both the shipping and receiving departments. The extent to which these and other measures are practicable will naturally vary with the size of the organization and the personnel employed.

The detailed scrutiny and check of cash transactions of large companies can be performed more economically by permanent company employees. Where such a check is provided, the accountant will modify his program accordingly. Where the internal check and control are necessarily limited or severely restricted the examination to be made will be more comprehensive in character but no examination should be regarded as taking the place of sound measures of internal check and control, except in cases where the organization is so small as to make adequate internal check impracticable. Except in the case of a small business, the cost of a detailed audit would be prohibitive, and the problem is to develop a general system of examination under which reasonably adequate safeguards may be secured at a cost that will be within the limits of a prudent economy. In the large majority of cases a detailed audit is not justified and the accountant relies on various test-checks of the records. The extent of the examination and of these test-checks is essentially a matter of judgment which must be exercised by the accountant, based on his experience, on his knowledge of the individual situation and on the extent of the internal check and control.

An accountant's examination of financial statements deals with those matters upon which he, as an accountant, is qualified to pass. He is not qualified, and thus should not undertake, to pass upon legal matters such as the status of titles, patents or franchises. Engineering matters, such as the adaptability of a plant to a particular product or an appraisal of its present value, are also outside his field. His examination, however, can not be confined entirely to the books of account. In regard to endorsements, guaranties, litigation, claims for damages and other contingent liabilities, which may materially affect the financial position but may not be reflected on the formal records, he is charged with the duty of making reasonable inquiries. Replies to the inquiries in many cases will be furnished by officers and employees on whose statements, in the absence of conflicting evidence, he is entitled to rely. To ensure that adequate consideration shall be given to these matters it is the common practice, when making such inquiries, to obtain written statements from appropriate officers or employees.

While it is impracticable, as already stated, to set forth in any single program procedures which will fit the widely varying situations which will be encountered, the value of a program as a guide has been so generally recognized that one is presented in the succeeding paragraphs. Many of the procedures suggested will apply in most cases but there are few cases where all of them will be used. The particular program chosen is intended for an examination, made for a report to stockholders or for bank-credit purposes, of the statements of a small or moderate-sized manufacturing or merchandising concern which has a reasonable system of internal check and control.

The scope of the examination and the extent of the detailed checking must be determined by the independent public accountant in the light of the conditions in each individual company. If there is little or no system of internal check, the client should be advised that a more detailed examination than that outlined hereafter is necessary if an unqualified report is to be furnished. If there is an adequate system of internal check, certain parts of the detailed procedure may be unnecessary.

For the sake of simplicity, the procedure suggested is submitted in the form of an audit program with such comments as seem called for on matters of principle. The procedure will not necessarily disclose defalcations nor every understatement of assets concealed in the records of operating transactions, or by manipulation of the accounts. Suggestions are made in the program as to the extent of information which should be given in the financial statements. While the final determination of this question rests with the company whose statements are the subject of examination, the accountant should use his influence to bring about adequate disclosure. If there is failure to disclose information which he believes to be material in the circumstances, his recourse is to comment on the matter in his report.

It should be understood that all of the work outlined need not necessarily be done as of the closing date of the period covered by the examination. It is frequently desirable to do the detailed work on the inventories or receivables as of an earlier date and, where conditions warrant it, this is satisfactory.

GENERAL

1. The accountant should determine (a) whether accepted accounting practices have been followed during the period under examination and (b) whether they have been changed in any material respect since the previous period. If the accountant is not satisfied in either respect and the amounts involved are material, reference thereto should be made in his report.

2. Compare the trial balances with the general ledger at the beginning and end of the period. Trace the items in the trial

balances to the balance sheets. Determine that no "contra" asset and liability have been improperly omitted from the balance sheet, that the assets and liabilities have been grouped in the same manner at the beginning and end of the period. Review the general ledger to ascertain if any transactions recorded in accounts opened and closed during the period have a bearing on the financial position at the close of the period.

3. A comparison of the balance sheets at the beginning and end of the period under review will usually reflect the major changes which have occurred during the period. This may assist in indicating special points that will require more than ordinary attention during the examination.

4. Minutes of directors' and stockholders' meetings should be read and all matters contained therein affecting the accounts should be noted.

CASH

1. Count cash on hand and compare with the recorded cash balance. This count should be made at the same time as notes receivable and investments are inspected or taken under control. Precautions should be taken to guard against the possibility of a shortage in one of these assets being covered up by temporarily converting other negotiable assets or withdrawing funds from the bank.

2. Ascertain when counting cash that all checks (other than those cashed for others) produced as part of the cash balance have been entered in the cash book prior to the close of the period. Note the dates and particulars of such checks and of all advances made from cash but not recorded on the books. Investigate closely advances to employees; if they are represented by personal checks see that these checks (and those cashed for persons outside the company) are deposited and paid before completion of the examination.

3. See that all cash funds are cleared of material amounts representing disbursements prior to the date of the balance sheet.

4. Obtain directly from all depositaries certificates as of the close of business on the closing date. Obtain reconciliation of the balances shown on the certificates with the balances shown by the cashbook, check-book stubs, or check registers, taking into consideration the outstanding checks, and other outstanding items.

5. Compare the checks returned by banks, item by item, with the cashbook for last month, or work backwards from the last day

of the period under examination until all recently drawn outstanding checks have been covered. As this procedure will not disclose any outstanding checks which may not be recorded, a better confirmation may be provided by comparing the outstanding checks shown on the bank reconciliation with checks returned by the banks in the subsequent month. Make special inquiry to ascertain if there are any unpaid checks long outstanding. See that no checks are drawn for cash or other purposes at the end of the period but not entered until the next period.

6. Ascertain that receipts shown in the cashbook as deposited on the last day of the period, but not credited by the bank on that day, have actually been deposited as claimed.

7. If currency and bank transactions are recorded together in the cashbook and the cash is not counted until after the close of the period under review, reconcile the bank balances as at the date of the cash count as well as at the date of the balance sheet. Cash on hand, which forms only a part of the balance, may be correct at the date of the count, but it does not follow that the total cash balance (including bank balances) is correct.

8. Check deposits shown on bank statements or pass-books for the last two or three days of the period with the cash-receipts book; determine that they were composed of bona-fide receipts and that no check drawn by the company was deposited in a bank without being deducted, prior to the close of the period, from the balance at the bank on which the check was drawn. In certain instances such comparison may be extended to include a check of original deposit slips or authenticated copies thereof.

9. Reconcile total deposits shown by the bank statements for at least one month with the total receipts shown by the cashbook; also reconcile total disbursements shown by the bank statements with total checks drawn as recorded in the cashbook for the same period.

10. Trace to the cashbook all checks outstanding at the beginning of the period that were not returned and checked in a previous examination.

11. Funds subject to withdrawal restrictions should be so described on the balance sheet.

NOTES RECEIVABLE

1. Prepare a list of notes receivable at the end of the period, showing dates, makers' names, due dates, amounts and interest rates, as shown by the book records.

2. Examine outstanding notes and compare with the notes receivable record or with the list (see also Par. 1 under Cash). Check dates and due dates. Trace into the books of the company cash received for notes matured since the close of the period and therefore not presented for examination; when notes are in the hands of attorneys or banks for collection, obtain confirmation from the holders. If notes have been discounted obtain acknowledgment from the discounting banks.

3. Give consideration to the probable value of the notes, particularly of renewed notes, and to the adequacy of the reserve provided. Ascertain the value of any collateral security for notes. The notes may be worth no more than the collateral, especially as collateral is usually required from debtors of doubtful standing.

4. The best verification of notes receivable is written confirmation by the debtor that the notes are bona-fide obligations, although such confirmation is not usually considered necessary in the case of companies having an adequate system of internal check. When this course is followed, mail personally the requests for confirmation in envelopes bearing the accountant's return address and enclose return envelopes addressed to the accountant.

5. Notes, including instalment notes, of a material amount maturing later than one year from the date of the balance sheet should be shown separately thereon unless trade practice warrants a different treatment. Balance sheets of businesses whose sales are largely instalment sales should show the notes receivable in some detail.

6. Notes from stockholders, directors, officers and employees and also notes arising from transactions outside the ordinary business of the company should be shown separately on the balance sheet.

7. Notes of affiliated concerns should not be included with customers' notes on the balance sheet even though received in respect of transactions in the ordinary course of business. They may be shown as current assets, investments or otherwise as the circumstances justify; inclusion as current assets is allowable only if the debtor company has a satisfactory margin of current assets over current liabilities including such notes.

8. The balance sheet should carry a footnote under "contingent liabilities" showing amount of unmatured discounted notes (see Par. 2 above).

1. Obtain lists of customers' balances open at the end of the period, with the amounts classified according to age. Foot these lists and compare them in detail with the customers' accounts in the ledgers. Note on the lists any amounts paid since the date of closing.

2. If separate ledgers are kept, reconcile the total of the lists of outstanding accounts with the controlling account in the general ledger. In this reconciliation credit balances in the customers' ledgers will be offset against the total of debit balances but on the balance sheet such credit balances should be included among the liabilities. (Similarly any debit balances in the accounts-payable ledgers should be appropriately classified.)

3. Examine the composition of outstanding balances. A customer may be making regular payments on his current account while old items, perhaps in dispute, are carried forward. Discuss disputed items and accounts that are past due with the credit department or with some responsible officer, and make such inquiries as are deemed necessary in order to form an opinion of the worth of the accounts and of the sufficiency of the reserve for bad and doubtful accounts. In the balance sheet the reserve should be shown as a deduction from the corresponding assets.

4. When bad debts have been written off, see that the action has been approved by responsible authority.

5. Inquire into the practice regarding the granting of trade discounts and so-called cash discounts if greater than two per cent and regarding freight allowed by the company. If such prospective allowances have not been deducted from accounts receivable, an appropriate reserve is required. Make inquiries as to customers' claims for reduction in prices and for allowances on account of defective material in order to ascertain that sufficient reserves have been established.

6. Make inquiries to determine that goods consigned to customers or agents, or goods under order from customers for future delivery, title to which has not yet passed to customers, have not been included in accounts receivable. Such merchandise should be carried in the inventory on the usual basis of pricing.

7. The best verification of accounts receivable is to communicate directly with the debtor regarding the existence of the debt, and this course may be taken after arrangement with the client.

While such confirmation is frequently considered unnecessary in the case of companies having an adequate system of internal check, it is one of the most effective means of disclosing irregularities. If it is to be undertaken, mail personally the requests for confirmation, after comparing them with the lists of outstanding accounts, in envelopes bearing the accountant's return address and enclose return envelopes addressed to the accountant.

8. If accounts of a material amount, including instalment-sales accounts, mature later than one year from the date of the balance sheet they should be shown separately thereon unless it is impracticable to segregate the proportion maturing beyond a year or trade practice warrants a different treatment. In that event the balance sheet should carry an explanatory note.

9. Accounts receivable from stockholders, directors, officers and employees, unless for ordinary and current trade purchases of merchandise, should be shown separately on the balance sheet. Deposits as security or guaranties and any other extraordinary items should also be shown separately.

10. Accounts receivable from affiliated concerns, even though arising from transactions in the ordinary course of business, should be shown separately on the balance sheet. Accounts with affiliated companies may be shown as current assets, investments or otherwise as the circumstances justify. They may properly be included as current assets only if the debtor company has a satisfactory margin of current assets over current liabilities including such accounts.

11. The amount of any accounts receivable that have been hypothecated or assigned should be so shown on the balance sheet.

SECURITIES

1. Obtain or prepare a list of securities owned showing particulars such as:

Description of security (give interest rate of bonds)
Denomination of bonds or par value of shares
Number of shares and face value of bonds
Cost of securities and amount at which carried on the books
Interest and dividends received during period under examination
Market quotations, if available
Location of securities, and if hypothecated, with whom and for what purpose.

2. Compare this list with the corresponding ledger accounts and ascertain the basis on which the securities are carried on the books.

3. Examine the securities listed or obtain confirmation from the holders if any are held by depositaries or others for safekeeping or as collateral. Make this examination of securities as close to the date of the balance sheet as possible (see also Par. 1 under Cash). It is more satisfactory to inspect the actual securities than to account for their disposition subsequent to the date of the balance sheet.

4. See that certificates of stock and registered bonds are made out in the name of the company or, if they are in the names of others, that they are so endorsed as to be transferable to the company or are accompanied by powers of attorney.

5. Examine coupons on bonds to ascertain that unmatured coupons are intact.

6. Confirm with transfer agents the ownership of certificates out for transfer.

7. Ascertain that the totals of dividends and interest received by the company as shown by the list (Par. 1) have been duly recorded, and that the income from securities shown in the profit and loss account is correctly reported.

8. Examine brokers' advices in support of the purchase and sale prices of securities bought and sold through them.

9. Confirm the cash-surrender value of life-insurance policies of which the company is the beneficiary and any policy loans by reference to the insurance policies or by correspondence with the insurance companies.

10. Examine mortgages and, if important in comparison with total assets, obtain confirmation.

11. The amount of securities that are considered to be readily convertible into cash and in which surplus funds of the company have been invested temporarily should be shown on the balance sheet under current assets. Where stocks and bonds represent control of or a material interest in other enterprises and have a value to the company aside from their dividend or interest return, they are more in the nature of permanent investments to be shown below the current assets in the balance sheet. Securities not readily marketable should be excluded from current assets.

12. If the total market value of securities included under current assets is less than the total book value by any material

amount, a reserve for the shrinkage in value should be provided. If cost prices are used the quoted market values should be shown on the balance sheet.

13. If examination of available data, including market quotations or, in their absence, balance sheets and income accounts supplemented by information and explanations from responsible officials, indicates that there has been a substantial shrinkage in value of securities held for investment since their acquisition appropriate reserves should be provided or the facts should be disclosed in the financial statements.

14. When corporations have acquired their own stocks, such stocks should preferably be deducted from the capital stock or from surplus or from the total of the two at either par or cost as the laws of the state of incorporation and other relevant circumstances require. If acquired and held for a specific purpose, however, such temporary holdings may be treated as assets, but they should be shown as a separate item and not under current assets.

15. If any securities owned by the company have been hypothecated, this fact should be stated on the balance sheet.

INVENTORIES

1. The accountant's examination of inventories falls naturally into three main divisions:

(a) Accuracy of computations, footings and recapitulations.
(b) Basis of pricing.
(c) Quantities, quality and condition.

2. The responsibility of the accountant in the first two cases is clear: check the inventories sufficiently to be satisfied as to the substantial accuracy of the clerical work performed and that the goods are valued in accordance with the usual commercial practice—that is, at cost or market, whichever is lower or on some other reasonable basis which is accepted as sound accounting practice in the particular trade or business.

3. The duties and responsibilities of the accountant in the case of quantities, quality and condition of stock vary with the circumstances; but he must rely principally for information as to quantities, quality and condition upon the responsible officers and employees of the company. In the case of a business which does not call for technical knowledge and presents no substantial difficulties, the accountant, by special arrangement with his client, may be justified in assuming a greater degree of responsibility

than in cases where expert knowledge is essential. Make reasonable inquiries and tests to ascertain that quantities have been carefully determined and that quality and condition have received due consideration.

4. Obtain copies of company's inventory instructions and determine how complete the physical stocktaking has been or whether there has been substantial reliance on book inventories. In the latter case inquire how frequently they have been tested by physical inventories throughout the period. If the accountant can discuss the situation before the actual stocktaking, it is desirable that he do so and ascertain the methods to be followed.

5. Obtain original stock sheets if they are in existence. Test the final inventory sheets by comparison with the originals and with tickets, cards or other means used in recording the original count.

6. See that inventory sheets are signed or initialed by the persons responsible respectively for taking the stock, determining the prices and making the calculations and footings. Obtain from a responsible official a clear and detailed statement in writing as to the method followed in taking stock and pricing it and as to the quantity, quality and condition and the accuracy of the inventory as a whole.

7. Test the accuracy of the footings and extensions, especially of the larger items.

8. Make a test comparison of the inventories with the stock records, if these are maintained, in support of quantities, prices and values. Any material discrepancy should be satisfactorily explained.

9. See that goods which are not owned but are on consignment from others have not been included in the inventory.

10. See that goods set aside for shipment, the title to which has passed to customers, have not been included in the inventory.

11. Whenever a cost system is not adequately controlled by the financial accounting, special attention is required. There is always a possibility that orders may have been completed, billed and shipped but not have been taken out of the work-in-process records. This is the case especially where such reliance is placed on work-in-process records that a physical inventory is not taken at the end of the period to check their accuracy. In such cases compare sales for the month preceding the close of the fiscal period

with the orders in process shown by the inventory to see that goods which have been shipped are not erroneously included in the inventory.

12. See that no machinery or other material which has been charged to plant or property account is included in the inventory.

13. Make inquiries and tests to ascertain that purchase invoices for stock included in the inventory have been entered on the books. Look for post-dated invoices and give special attention to goods in transit.

14. If it is customary in the particular business to receive deliveries under purchase contracts which are not promptly billed, confirm the quantities delivered by communication with the contractor.

15. Ascertain that inventories are stated at cost or market prices, whichever are the lower at the date of the balance sheet, or determine that any other basis which has been adopted is in accordance with sound accounting practice in the particular trade or business. Deduct trade discounts in determining inventory cost prices. Cash discounts may or may not be deducted, depending upon the practice of the trade and of the particular company. Market prices may be determined by obtaining current quotations, consulting trade journals and by comparison with recent purchases. Replacement costs should be considered and also selling prices, less shipping and selling expenses.

16. In the case of raw materials and merchandise purchased make a test comparison of cost prices used with purchase invoices or other sources of information. A general examination and test of the cost system in force is the best means of checking the cost of the work in process and finished goods. See that no selling expenses, interest charges or administrative expenses are included in the factory overhead cost (except so far as administrative expenses apply to production); that any interdepartmental profits and, in the case of consolidated statements, inter-company profits, are eliminated from the inventories; and that the factory overhead cost is equitably distributed over the various departments, shops and commodities. Ascertain whether overhead allocation is based on actual production or normal capacity. Normal capacity is preferable.

17. If duties, freight, insurance and other direct charges have been added, the amounts should be tested to ascertain that they are proper.

18. Give consideration to the possibility that obsolete, excessive or damaged stock may be included in the inventories at greater than realizable values; make test of detailed stock records to determine if the quantities are reasonable in relation to average consumption and purchases; and discuss with responsible officials.

19. Make inquiry to ascertain if the company has discontinued the manufacture of any of its products during the year; if so the inventory of such products or parts thereof should be carefully scrutinized and provision made for anticipated losses.

20. In the case of part shipments or uncompleted contracts it is preferable not to take up profits except in cases where the information available clearly indicates that a partial profit has been realized after making provision for possible losses and contingencies. Ascertain from the contracts the selling prices for contract work in progress and if it is apparent that there will be a loss on the completed contract provision should be made for the estimated loss.

21. Check the inventory total by the "gross profit test", comparing the percentage of gross profit with that of previous years. In a business in which the average gross profit has been fairly constant, this test is satisfactory; if the rate of gross profit is not maintained and the discrepancy can not be explained by a rise or fall in the cost of production or in the selling price, the difference may be due to errors in the inventories.

22. Ascertain that the inventories at the beginning and at the end of the period are stated on the same basis, determined generally in the same manner, or if not, the approximate effect on the operating results.

23. Advance payments on account of purchase contracts for future delivery should preferably be shown in the balance sheet under a separate heading.

24. If stocks have been hypothecated, that fact and the book value of the stocks hypothecated should be stated on the balance sheet.

PROPERTY, PLANT AND EQUIPMENT

1. Summarize the accounts grouped under the heading property, plant and equipment (such as land, buildings, plant and machinery) so as to show balances at the beginning of the period, a summary of changes during the period and the balances at the end of the period.

2. See that the total of the balances at the beginning of the period agrees with the total property, plant and equipment as stated in the balance sheet at that date; and that the balances at the end of the period agree with the amount shown on the balance sheet at the latter date. Property, plant and equipment are usually carried at cost but if any other basis is used it should be stated on the balance sheet as concisely as the material facts will permit. If appraisal figures are used, the date of appraisal should be given.

3. The accountant should satisfy himself as to the propriety of capitalizing the additions to property, plant and equipment during the period. Examine authorizations for expenditures made during the period; if costs of additions to property, plant and equipment have exceeded the amounts authorized ascertain the reasons. Authorizations should indicate the accounts to which expenditures are to be charged, should bear the approval of a responsible official, and should show the nature of the work.

4. When authorizations do not specify whether the work is a repair, a replacement or an actual addition or where there are no formal authorizations, use whatever means may be available to ascertain the character of the work. Determine that amounts capitalized represent real additions or improvements.

5. Examine the methods of distributing the payroll and material and supply charges in sufficient detail to determine that the charges to construction jobs are reasonable. This applies to construction work done by the company's own employees. Examine invoices and other evidence for construction work by outside contractors; ascertain that liability for instalments owed for construction work in progress has been taken up on the books.

6. While it may be considered permissible in the case of construction work done by the company's own employees to capitalize a portion of the overhead cost, e.g., time of superintendent and his clerical force employed on construction work, etc. (but not general administrative expenses) such charges should be carefully scrutinized, inasmuch as it is possible that the overhead charges of a plant may not be decreased to any great extent when additions are not under way; consequently, the absorption of part of these charges in property accounts when construction is in progress may reduce the operating cost below that of periods in which no such work is being done, and may unduly affect comparisons between years.

7. For purchases of real estate examine vouchers in support of payments made. Title deeds bearing endorsement of public recording officials are supporting evidence of such purchases. Verification of present title and search for encumbrances of record are legal matters which are not within the province of the accountant.

8. In the case of leasehold property examine the leases, noting their terms. See that improvements, etc. on such property are being written off over a period not in excess of either the duration of the lease or the estimated life of the improvements.

9. Ascertain the methods used in providing reserves for depreciation of buildings, machinery and other equipment and also for depletion of natural resources. Investigate charges against the reserves. If the accountant is in doubt as to the adequacy of the current provision or the accumulated reserve shown on the balance sheet he should make suitable comment in his report.

10. Make inquiries to determine that proper record is made when property is sold, abandoned, destroyed by fire or otherwise put out of service. Any loss not provided for by depreciation or recoverable through insurance, salvage or otherwise should be written off.

11. Many of the foregoing suggestions apply only to property additions during the period under review. In addition, it is well to obtain general information relative to the composition of real estate, building and machinery accounts to ascertain the principal property represented and the manner in which the accounts have been built up for some years past, if not from the inception of the business.

12. Construction work in progress and material on hand at the end of the fiscal period which is designated for use in construction should be shown on the balance sheet under the heading property, plant and equipment and not as part of the inventories.

INTANGIBLE ASSETS

Intangible assets such at patents, trademarks, franchises and goodwill should, if practicable, be shown separately in the balance sheet. Ascertain the basis on which they are carried in the accounts and the company's policy as to amortization of them.

DEFERRED CHARGES

1. Under this caption are included unexpired insurance, prepaid interest, taxes, royalties and other prepaid expenses and also

bond discount, development and organization expenses and other deferred items unamortized.

2. Check the mathematical accuracy and ascertain that they are proper amounts to carry forward as a charge to future operations. Whenever possible obtain documentary evidence in support of the items carried forward; for example, in the case of unexpired insurance examine the policies to ascertain dates of expiration, the amount of the premiums and the proportion to be carried forward; in case of prepaid royalties examine the agreements or contracts. Any adjustment of premiums for compensation insurance should be based upon the actual, not the predetermined, payroll.

3. Make inquiries to determine the company's policy as to amortization of deferred charges, such as whether bond discount is being amortized on a straight-line basis or bond-outstanding method or otherwise. If development and similar expenditures are deferred, they should be written off over a reasonable period having regard to the character of the expenditures.

4. As prepaid expenses and deferred charges may be considered to include two classes of items which differ somewhat in their nature different treatment is sometimes accorded them. Prepaid expenses, as representing those items which eventually will be included in manufacturing or other operating expenses may, if desired, be set up as a separate item under deferred charges or may be included as a separate caption on the balance sheet.

NOTES PAYABLE

1. Obtain or prepare a schedule showing the dates and amounts of notes payable, interest rates, due dates, names of payees, collateral, endorsers and interest accrued to the date of the balance sheet.

2. See that the schedule agrees with the notes-payable book and with the balance of the notes-payable account in the ledger.

3. Confirm notes payable by obtaining from all banks in which the company maintains balances and from all note-brokers with whom the company transacts business statements of notes and drafts discounted or sold and not paid prior to the date of the balance sheet and details of collateral held, endorsements, etc. Check the schedule with these statements. Confirm other notes payable recorded on the books, if important in amount.

4. See that there is an adequate control of notes payable and ascertain, preferably by examination of the cancelled notes, that

notes paid during the period have been properly discharged. An analysis of the interest account may provide additional information regarding interest-bearing liabilities.

5. Hypothecation of any of the company's current assets or investments as collateral for notes payable or other liability should be noted on the balance sheet.

6. Notes payable to affiliated companies and to stockholders, directors, officers and employees should be shown separately on the balance sheet.

ACCOUNTS PAYABLE

1. Obtain a list of the recorded accounts payable and make appropriate check with the ledger accounts or with open items in the voucher register, according to the system in use. Reconcile the total with the controlling account in the general ledger. Investigate any large balances which do not represent specific or recent items. Obtain confirmation from the creditor if any account appears to be irregular. If there are accounts in dispute, large enough to affect substantially the total of current liabilities, investigate the causes of dispute.

2. The following procedures are helpful in determining that all liabilities are included in the accounts:

   (a) Review vouchers entered in the voucher register and/or payments shown by the cashbook subsequent to the date of the balance sheet to ascertain whether any of them are applicable to the period under review.

   (b) Examine bills on file not vouchered or entered to ascertain if any of them belong to the period under review.

   (c) Make a test examination of the monthly statements received from creditors having large balances.

   (d) Examine receiving records for the last day of the period for the purpose of ascertaining that the corresponding liabilities are included.

3. Inquire if any goods have been received on consignment, and if so examine the pertinent records and ascertain that liability has been set up for all such goods sold.

4. As an additional precaution against the omission of liabilities obtain in writing from a responsible official of the company (1) a statement that all outstanding liabilities for purchases and expenses have been included in the accounts and (2) a summary of any liabilities for legal claims, infringements of patents, claims for damages, etc. not included in the accounts. It is advisable to obtain the signature of the president or other senior officer to this

statement as only a senior officer of the company may know the extent of such obligations.

5. Liabilities to affiliated companies and advances by stockholders, directors, officers and employees if material in amount should be shown separately on the balance sheet.

ACCRUED LIABILITIES

1. Interest, taxes, wages, etc., which have accrued to the end of the period under review but are not due and payable until a later date, are grouped on the balance sheet under "accrued liabilities". Special attention is directed to the following liabilities:

2. *Interest payable.* Make inquiries to ascertain whether provision has been made for interest due or accrued. See that interest on bonds and notes payable has been provided for and give consideration to the possibility that interest may be payable on past-due book accounts, on loan accounts of officers or directors and on judgments, overdue taxes and other liens.

3. *Taxes.* Ascertain the amount of accrued federal, state and local taxes including any liability for taxes withheld. In the case of some local taxes it may be necessary to inquire of the taxing authority as to the period for which taxes accrue. Determine the present situation relative to federal income taxes for the current and prior years, i. e., what years have been examined, and what years have been finally closed. If there are in dispute any items of material importance on which a difference of opinion exists, adequate provision should be made or the situation should be disclosed in a footnote to the balance sheet, failing which reference should be made in the accountant's report.

4. *Salaries and wages.* If the date of the balance sheet does not coincide with the date to which the last payroll of the period under review has been computed, ascertain the amount accrued to the date of the balance sheet. Inquiries should also be made as to any profit-sharing or bonus plans.

5. *Traveling expenses and commissions.* See that provision has been made for unreported expenses of traveling salesmen and for accrued commissions.

6. *Legal expenses.* Provision should be made for any accrued liability for legal expenses.

7. *Damages.* Inquire if there are any claims or suits for damages not covered by insurance; if any evidence is found indicating such

liability, obtain information on which to base an opinion as to the amount that should be set up as an accrued liability or as a reserve against probable loss.

CONTINGENT LIABILITIES

1. Make inquiries relative to the existence of contingent liabilities. Such liabilities will usually be of the following nature:

2. *Notes Receivable Discounted.* (See procedure suggested under notes receivable.)

3. *Indorsements and Guaranties.* Ascertain from responsible officers of the company whether any indorsement of unrelated paper or any guaranties have been made and if so what security has been received to protect the company. This inquiry is especially necessary if it is known that any of the officers are interested in other enterprises.

4. *Judgments.* Any liability for judgments not appearing on the records of the company may be discovered by searching the public records; but this is within the province of lawyers, not of accountants. Many business men will not permit entry in their books of a judgment from which they intend to appeal, and it becomes difficult for the accountant to find any evidence of such a liability except by inquiry of responsible officials. Make such inquiries. If any liability exists, though not finally determined, appropriate mention of the facts should be made in a footnote to the balance sheet.

5. *Unfulfilled contracts.* Where the nature of the business requires large purchase orders for future delivery ask for copies of such purchase orders. If the contract prices are higher than market prices and the purchase contracts are not protected or only partly protected by firm sales orders, it may be necessary to set up a reserve for possible loss.

6. *Damages.* There may be claims or suits for damages not covered by insurance or by reserves provided therefor. If evidence is found indicating a liability of this nature, request full information so as to be able to form an opinion as to the amount which should be stated as a contingent liability.

7. *Liability for real-estate bonds and mortgages.* Investigate the possibility that any liability may result from the sale by the company of property subject to mortgage. If property subject to a mortgage has been sold there may be a contingent liability under the bond unless the mortgage has been satisfied, the satisfaction recorded and the bond cancelled.

8. Notation should be made on the balance sheet relative to contingent liabilities where the amounts involved are or may become material. In case of claims, litigation and other matters involving a legal determination it may be advisable for the accountant to obtain information, preferably in writing, from the company's legal advisors as to the probable extent of the liability.

FUNDED DEBT

1. Obtain from the trustee a statement of the amount of bonds outstanding, in confirmation of the liability shown on the balance sheet. Check the accrued liability for interest on outstanding bonds, and reconcile the relative interest expense taken up in the profit and loss account.

2. Examine bonds redeemed during or prior to the period under review to see that they have been properly cancelled, or, if they have been destroyed, the statement obtained from the trustee should show the net amount outstanding.

3. Ascertain the sinking-fund requirements of the bond indenture and see that due consideration has been given to them. Any default in the interest or sinking-fund requirements that may exist should be mentioned on the balance sheet.

4. Give consideration to any other important stipulation of the trust indenture concerning the accounts. Trust indentures, for example, sometimes stipulate that current assets shall be maintained at a stated amount in excess of current liabilities.

5. Check the liability on account of mortgages or other liens so far as the company's records afford data. Confirm the amounts shown by the books of account and the interest rates, due dates, etc. This may be accomplished by obtaining certificates from the mortgagees.

6. The balance sheet should show the amount of bonds issued and in treasury or sinking funds, and also the rates of interest and the dates of maturity or, in the case of serial bonds, the annual or periodical maturities. Serial bonds, notes and mortgage instalments due within one year should be separately disclosed and if material should be included with the current liabilities.

RESERVES

1. Analyze all the reserves to determine the changes during the period, whether they be reserves deducted from the respective assets or shown on the liability side of the balance sheet. Give

careful consideration to the accounting practices of the company in setting up reserves and in making charges against them.

2. If the general or contingency reserves are of sufficient importance in comparison to the financial position or earnings of the company, it may be desirable for the company to include with its financial statements a summary of changes in reserves during the period.

CAPITAL STOCK

1. In the case of companies which issue their own stock, examine the stock records and stock certificate books to ascertain the amount of capital stock outstanding. See that the company is complying with the requirements of laws imposing transfer taxes.

2. If a trust company is the registrar of the capital stock, obtain from the registrar and/or transfer agent a certificate as to the number of shares of capital stock issued and outstanding.

3. If any stock has been sold during the period under review see that the cash or other consideration for which the stock was issued was in accord with authorization of the directors. Make inquiries as to the existence of any stock options, warrants, rights or conversion privileges. If any exist, details should be given on the balance sheet.

4. If stock has been subscribed on an instalment plan ascertain whether or not any payments are in arrears. If special terms have been extended to any stockholder, examine the minutes of the board of directors to see that such terms have been approved.

5. The capital stock or stated capital should be shown on the balance sheet in accordance with the statutes of the state under the laws of which the corporation is organized, the articles of incorporation and the corporation's minutes. It should be borne in mind that the laws of most states have special provisions relative to the acquisition of treasury stock by a corporation.

6. Each class of stock should be stated separately on the balance sheet, with the amount authorized, issued and outstanding and the par value per share. If the stock is of no par value the stated or assigned value per share, if any, should be shown and the redemption price or the amount of preference upon liquidation. If any stock of the company is held in the treasury it should preferably be shown as a deduction from capital stock or from surplus or from the total of the two, at either par or cost, as the laws of the state of incorporation and other relevant circumstances require. If it is included on the asset side of the balance

sheet the circumstances justifying such treatment should be indicated in the caption or in a footnote to the balance sheet.

7. The total amount of dividends or the dividends per share on outstanding cumulative preferred stock which are in arrears should be stated on the balance sheet. All dividends declared but not paid at the date of the balance sheet should be included in the current liabilities.

SURPLUS

1. Analyze the surplus accounts for the period covered by the examination. Reconcile the opening balance with the surplus shown in the previous balance sheet and consider the propriety of the entries made in the surplus account.

2. Check by reference to the minutes of directors' meetings the dividends declared or paid during the period under review. If stock dividends have been distributed, ascertain that the treatment on the books is in accordance with the minutes. Adequate disclosure should be made.

3. Where practicable the nature of the surplus should be shown on the balance sheet divided under principal classifications such as:

(a) Earned surplus (or deficit).
(b) Capital or paid-in surplus.
(c) Surplus arising from revaluation.

If there are any restrictions on the surplus by reason of state laws, charter provisions, etc., such as in the case of reacquired shares, the nature of the restrictions should be indicated.

4. The balance sheet should show as "surplus arising from revaluation", or by some similar title, any credit resulting from increasing the book value of capital or other assets by revaluation, whether on the basis of independent appraisal or otherwise.

5. Unrealized profits should not be credited to income account either directly or indirectly, by charging against such unrealized profits amounts which would ordinarily be chargeable 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 the case of inventories in industries (such as the packing-house industry) in which it is a trade custom to take inventories at net selling prices which may exceed cost.

6. Intercompany profits on sales of securities or other property should not be taken into the consolidated surplus account until realized by sale outside the group of affiliated companies.

7. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise require to be made against income. 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 stockholders as in reorganization.

8. 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.

9. If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of the property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.

Profit and Loss Statement

General

1. Analyze the profit and loss account for the period and obtain or prepare a working profit and loss statement in as much detail as is readily available. The extent of the examination to be made is dependent upon the classification of the accounts and the factors outlined at the beginning of Section II. The accountant should satisfy himself that the income received and the expenditures made are properly classified insofar as the facts are known to him or ascertainable by reasonable inquiry.

2. The profit and loss statement should be prepared so that it will be reasonably informative. It is usually helpful to obtain corresponding figures for one or more preceding years for comparative purposes as an aid in ascertaining and inquiring into

unusual items during the year under review. The budgets adopted by the company and monthly financial statements, where available, should also be obtained for comparison with the annual results. Determine so far as possible that the company has applied its accounting principles consistently throughout the period and see that adequate explanation is made in the profit and loss statement of any departure from such principles.

3. A satisfactory form of profit and loss statement is given in Section IV, but any other form giving similar information may suffice. Conditions vary so widely that it is not practicable to submit a program for the examination of the profit and loss statement. Certain suggestions only are given relative to the individual classifications.

SALES AND COST OF SALES

1. Whenever the necessary statistics are available it is desirable to reconcile the quantities of the principal products sold with the production or purchases during the period, taking into consideration the inventories at the beginning and end of the period.

2. Ascertain by reference to the shipping records that the sales books were closed as of the last day of the period, and that no goods shipped after that date are included in the sales of the period. When a first examination is made it is well to ascertain similarly that the sales at the beginning of the period were recorded in accordance with the dates of shipment.

3. Allowances to customers for trade discounts, outward freights, reductions in price, etc., should be deducted from gross sales. It is sometimes difficult to distinguish between deductions from sales and selling expenses, and the classification adopted by the company should be accepted if reasonable and consistently applied. Price concessions, allowances and discounts are sometimes treated differently in the same trade or business. The net sales figure, after making such deductions from the gross volume of business recorded on the books, should be shown in the profit and loss statement, unless undesirable for trade reasons. Inquire as to the methods adopted to safeguard credits to customers for returned merchandise, claims, rebates, etc. Make a test examination to find out if the procedure is being followed.

4. Cost of sales includes all the costs in connection with buying and producing goods sold. Write-downs of inventory to market prices at the end of the period may have a material effect on the percentage of gross profit to sales, and where such write-downs

result from general business conditions rather than from the buying or production policies of the company, it may be desirable to show them separately. See that interdepartmental profits and, in the case of consolidated statements, intercompany profits are eliminated; if this is impracticable, the reason should be stated. If the accountant is in doubt as to the adequacy of the current provision for depreciation he should make suitable comment in his report.

GROSS PROFIT ON SALES

Gross profit on sales is ascertained by deducting cost of sales from net sales. Compute the ratio of gross profits to net sales; compare it with that of previous years, and make inquiries to account for any marked variation.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Examine the ledger accounts for selling, general and administrative expenses to see that they are properly classified and that credits which should be shown elsewhere are not improperly deducted. Extraordinary items of material significance should be shown separately.

NET PROFIT ON SALES

Net profit after deducting expenses but before other income and other charges is usually a significant figure, and determination of percentage to sales and comparison with previous years is desirable.

OTHER INCOME

Income derived from sources other than sales, such as income from investments, interest, discounts, etc., should appear under the heading "other income". The accountant should assure himself of the propriety of including each item as income. If there is extraordinary income of a material amount, proper disclosure should be made. If stock dividends received have been included as income, that fact as well as the basis on which they have been taken up should be indicated. If the company holds any of its own capital stock in its treasury dividends thereon should not be treated as a credit to the income account.

OTHER CHARGES

Interest charges on funded debt, notes payable and other obligations, losses on securities sold and other non-operating or extraordinary charges are usually detailed under the heading "other charges". Investigate these generally and see that they are properly included under this heading rather than as cost of sales or expenses. Provision for income and capital stock and excess-profits taxes may be included here or deducted as a separate item in the profit and loss statement. Minor surplus adjustments affecting prior periods are preferably included under this caption since it is impossible to close the accounts of any one period without continual overlapping of miscellaneous income and expense items.

SECTION III

Modifications of Program for Larger or Smaller Companies

Section II contains an outline of an examination for a small or moderate-sized company with a reasonable system of internal check and control. It has been mentioned that wherever there is an extensive system of internal check the accountant should determine the extent to which he would be justified in reducing the amount of the detailed checking which otherwise he might consider necessary, but that only in a large organization is it usually possible to obtain the most satisfactory separation of functions and duties. In a very small organization or one having a highly restricted system of internal check and control, it will be necessary to make a more detailed examination than that heretofore outlined.

The importance of judgment in selecting the tests to be made by the accountant must be again emphasized. A rigid program is undesirable and would not achieve its purpose. The following suggestions are submitted as indicative of modifications which may be made in the scope of the examination outlined in Section II.

CASH

Where there are a great many bank accounts with a number of relatively small working funds which are reconciled periodically by employees independent of the cashier's department, it may not be necessary for the accountant to reconcile all the working funds but only to do so for the principal bank accounts, accepting copies of reconciliations signed by internal auditors for the remainder. On the other hand, where the company does not deposit all of its receipts daily it may be desirable for the accountant to check cashbook footings in addition to the other steps described.

NOTES RECEIVABLE

Large instalment companies may have thousands of notes receivable which are controlled by a satisfactory internal check.

In such cases it may not be necessary or desirable for the accountant to examine every note or instalment account, but a reasonable test may be sufficient. On the other hand, if the company is small and has been accustomed to discount its notes receivable, special inquiry from all banks in which the company has maintained balances during the period may be necessary to determine the full contingent liability.

ACCOUNTS RECEIVABLE

If there are large numbers of customers and the customers' ledgers are kept by employees who do not have access to incoming cash or cashiers' records, who do not mail out the monthly statements nor initiate credits for returned goods or allowances, a relatively limited test of the individual customers' accounts may suffice. A more satisfactory check may thus be provided than would be obtained by a detailed examination of the accounts receivable of a company having inadequate internal control.

INVENTORIES

Many large companies maintain comprehensive continuous inventory records which are subject to periodic and independent physical stocktaking. In such cases the accountant should use his best judgment in determining the extent of the examination required, but the various points mentioned in the program regarding inventories given in Section II should be considered.

PROPERTY, PLANT AND EQUIPMENT

Many companies maintain separate plant records which are controlled on the general books. If all capital additions are budgeted and authorized in advance and later checked and approved in the controller's department, the vouching of the larger items may be all that is necessary. In the case of companies without adequate detailed records, a more extensive examination is required. It is not the accountant's function to determine that every minor charge is justified. He should acquaint himself with the policies of the company with regard to capital additions, replacements and repair charges and should satisfy himself that the total amount capitalized is reasonable, that plant units ascertained to have been abandoned are removed from the asset account, and that the depreciation reserves are being accumulated on some consistent and accepted basis.

LIABILITIES

In endeavoring to see that all liabilities are reflected in the balance sheet, the accountant should not go to the extreme of providing meticulously for every minor item that he happens to discover. There will always be overlapping items between years, which have no important bearing on the accounts. His function is to see that liabilities ascertainable by a reasonable examination are included in the balance sheet.

Contingent liabilities are apt to be numerous in large companies. In the ordinary course of business there is frequently a large number of outstanding claims or suits for damages and commitments of various kinds. It is often very difficult, if not impossible, to determine the amount in money that may be involved, since the nominal amount of a suit is no measure of the maximum amount that may have to be paid. It is generally recognized that such conditions exist and it is only necessary to refer to major or unusual situations. In case of claims, litigation and other matters involving a legal determination it may be advisable for the accountant to obtain information, preferably in writing, from the company's legal advisors as to the probable extent of the liability.

PROFIT AND LOSS STATEMENT

Reasonable substantiation of a condensed income account or profit and loss statement is usually not difficult whether in a large or a small company, and a great part of the work will already have been done in making the examination of the balance sheets at the beginning and end of the period. The separation of sales and deductions from sales, the determination of cost of sales and the classification of the various expenses and charges, however, are sometimes difficult in the case of a large company; and a good deal of reliance must necessarily be placed on the internal accounting classifications and control. Overhead is frequently distributed between operations or products or even between plants and this may make it difficult, if not impracticable, for the accountant to classify the summarized profit and loss statement in any greater detail than that followed by the company in its internal statements or to obtain the data necessary for that purpose from the underlying records. It is most important that the accountant obtain a thorough understanding of the accounting principles and classifications adopted by the company before making his examination of the profit and loss statement. It will then be necessary for him to use his judgment to determine the relative importance of the different items and the amount of detailed checking which he considers necessary.

In the case of a company of limited size or one having a highly restricted system of internal check and control a more detailed examination than that outlined in Section II may be necessary to determine the substantial accuracy of the profit and loss statement. This may take the form of a more extensive test of vouchers, a test of the payrolls and an analysis of expense accounts or such other procedure as the accountant believes will be most effective in the particular circumstances. As the financial statements as a rule are not intended for wide distribution, more details are usually included in the profit and loss statement.

CONSOLIDATED STATEMENTS

In the case of consolidated statements, it is frequently desirable to examine the accounts of operating subsidiaries as of a date a few months prior to the close of the parent company's fiscal year; otherwise the issuance of the financial statements might be unduly delayed. In such cases a review of the transactions between the date of the examination and the date of the consolidated accounts should be made. This procedure is particularly suitable to the examination of the accounts of such companies as public utilities. The accountant should satisfy himself that in the interim there have been no important transactions outside the ordinary course of business and that the financial position of the subsidiaries at the date of the consolidated balance sheet is not materially different from that at the date of the earlier examination.

In the case of foreign subsidiaries in particular it is frequently impossible to receive the financial statements as of the date of the consolidated balance sheet in time for inclusion in such balance sheet and it is therefore customary to include the accounts of certain of the subsidiaries, in cases where they are consolidated, as of an earlier date. Care should be taken to see that there have been no unusual transactions in the interim and that shipments and remittances within the consolidated group of companies up to the date of the consolidated balance sheet are taken into consideration. The operations of each company should cover a full fiscal period. If foreign subsidiaries are included in the consolidated balance sheet the basis of conversion of foreign currencies should be indicated; and the treatment of exchange adjustments should be disclosed.

SECTION IV.

Financial Statements and Accountant's Report

The accountant should consider and be sympathetic with the growing demand that statements should be more informative and more easily understood by the reader and may well urge his client to meet this demand. For example, balance sheets and profit and loss statements might be presented in comparative form; or there might be given supporting and supplemental statements showing changes in investments, property, plant and equipment and reserves or more condensed summaries of changes in the financial position.

The form of the balance sheet and profit and loss statement will necessarily be modified to meet the requirements of each particular situation. The following forms are submitted as satisfactory for the average industrial company:

Form of Balance Sheet

Assets

Current Assets:

Cash in banks and on hand

Marketable securities (state basis)

Notes and accounts receivable:

Customers:

Accounts receivable

Notes receivable

Others

Less—

Reserve for doubtful notes and accounts

Reserve for discounts, freight, allowances, etc.

Inventories: (state basis)

Raw materials and supplies

Work in process

Finished goods

Other current assets:

Indebtedness of stockholders, directors, officers and employees (current)

Indebtedness of affiliated companies (current)

Other items (describe)

Total current assets

Investments: (state basis)

Securities of affiliated companies

Indebtedness of affiliated companies—not current

Other (state important items separately)

Property, Plant and Equipment: (state basis)

Land used for plant

Buildings used for plant

Machinery and equipment

Patterns and drawings

Office furniture and fixtures

Other items (describe)

Total property, plant and equipment

Less—

Reserves for depreciation, depletion, amortization, etc.

Intangible Assets: (describe)

Deferred Charges:

Prepaid expenses, interest, insurance, taxes, etc.

Bond discount

Other deferred charges (describe important items)

Other Assets: (describe)

Total

Form of Balance Sheet (Cont'd)

Liabilities

Current Liabilities:
- Notes payable:
  - Banks
  - Brokers (commercial paper)
  - Merchandise creditors (including notes given for machinery, equipment, etc., purchased)
  - Acceptances (for merchandise and raw material purchased)
  - Stockholders, directors, officers and employees
- Accounts payable and accrued expenses
- Advances from stockholders, directors, officers and employees
- Accrued interest
- Provision for federal and state taxes
- Other current liabilities (describe)

Note: Where assets have been pledged against any of the foregoing liabilities, that fact and the nature and amount of the assets pledged should be stated.

Total current liabilities

Funded Debt: (describe)
- Bonded debt
- Mortgages
- Other funded indebtedness (describe)

Total funded debt

Reserves: (describe by major classes)

Capital Stock: (describe)
- Preferred stock
- Common stock

Surplus:
- Capital or paid-in
- Arising from revaluation (see Par. 3 under "Surplus")
- Earned (or deficit)

(A summary of surplus accounts for the period should be shown either in the balance sheet or in a separate statement)

Total

(a) Contingent liabilities not covered by reserves should be given due consideration.

(b) If there be arrears in cumulative dividends state the amount or the rate per share.

(c) Any default in the principal, interest or sinking fund provisions of funded debt should be stated and the relative amounts involved.

FORM OF PROFIT AND LOSS STATEMENT

Gross sales ....

Less outward freight, allowances and returns..........

Net sales ....

Cost of sales..........

Gross profit on sales..........

Selling, general and administrative expenses..........

Net profit before other income and charges..........

Other income:

Income from investments..........

Interest on notes receivable, etc..........

Other non-operating or extraordinary income (separately shown)..........

Other charges:

Interest on funded debt (and amortization of bond discount)..........

Interest on notes payable..........

Other non-operating or extraordinary charges (separately shown)..........

Provisions for income taxes..........

Total deductions ....

Net profit (loss) for period carried to surplus..........

NOTE: It is desirable to indicate the amount of provision for depreciation, depletion, etc., for the period.

ACCOUNTANT'S REPORT

The accountant's report or certificate should be as concise as is consistent with a clear statement of his opinion on the financial statements submitted. Explanations and disclosures which he believes to be desirable regarding accounting principles adopted should be inserted in the financial statements or in his report. Attention is directed to the importance of stating any qualifications clearly and concisely. Distinction should be made between those comments intended to be merely informative or to state the limitations of the scope of the accountant's work (e.g., where part of the work has been performed by other accountants), and those which indicate dissent from particular practices of the company. Care should be exercised to avoid making any statement that is not literally true or which might give rise to unwarranted implications. A suggested form for the accountant's report follows:

To the XYZ Company:

We have made an examination of the balance sheet of the XYZ Company as at December 31, 1935, and of the statement of income and surplus for the year 1935. In connection therewith, we examined or tested accounting records of the Company and other supporting evidence and obtained information and explanations from officers and employees of the Company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

In our opinion, based upon such examination, the accompanying balance sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the XYZ Company during the year under review, its position at December 31, 1935, and the results of its operations for the year.

Notes

1. It is contemplated that, before signing a report of the type suggested, the accountant will be satisfied that his examination has been adequate and in conformity with the principles outlined in this bulletin.
2. The report should be addressed to the directors of the company or to the stockholders, if the appointment is made by them.
3. The statement of what has been examined would, of course, conform to the titles of the accounts or statements reported upon.
4. In the second sentence, any special forms of confirmation could be mentioned: e.g., "including confirmation of cash and securities by inspection or certificates from depositaries."
5. This certificate is appropriate only if the accounting for the year is consistent in basis with that for the preceding year. If there has been any material change either in accounting principles or in the manner of their application, the nature of the change should be indicated.
6. It is contemplated that the form of report would be modified when and as necessary to embody any qualifications. reservations or supplementary explanations.