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MEMORANDUM

ON

BALANCE SHEET AUDITS

JULY 31, 1913.

PRICE, WATERHOUSE & COMPANY
CHARTERED ACCOUNTANTS
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INTRODUCTION.

This memorandum has been issued with a view to furnishing assistants with a synopsis of the programme that should be followed in a balance sheet audit of an industrial concern. No matter how extensive one's experience may have been, or how careful and painstaking one may be, one is apt to overlook important matters in an audit, not necessarily on account of lack of either knowledge or experience, but on account of forgetfulness. It is felt that not only will the time devoted to a careful perusal of this memorandum be well spent, but it will also be to the advantage of the firm if it is followed by suggestions for improving the memorandum, either in additional notes on verification work general to all balance sheet audits, or in constructive criticism of the matters covered in the memorandum. In making suggestions it should not be forgotten that no attempt is made in the memorandum to cover audits of consolidated accounts, investigations for profits, detailed cash audits, the preparation of reports, matters arising in audits of particular industries, public utilities, railways, banks, etc., the treatment and settlement of adjustments, etc., etc.

GENERAL REMARKS ON A BALANCE SHEET AUDIT.

The scope of a balance sheet audit for a financial year of an industrial corporation may be said to embrace a verification of the assets and liabilities, a general examination of the profit and loss account, and incidental thereto, an examination of the system of accounting.

Before starting an audit, the auditor should furnish himself with a copy of the balance sheet at the beginning of the period to be audited, and a comparison should be prepared between this balance sheet and that at the end of the fiscal period, so that a comprehensive view may be had of the changes in the figures during the period under review. A statement of the disposition of the profits should then be prepared from this comparative balance sheet as a further aid in impressing the meaning of the figures upon the mind of the auditor.

Trial balances of the general ledger, both at the beginning and end of the periods under review, should be prepared in comparative form and checked with the ledger. The items in the trial balances should be traced into the balance sheets before the assets and liabilities are verified, to prove, among other things, that no "contra" asset and liability has been omitted from the accounts, that the assets and liabilities have been grouped in the same manner at the beginning and end of the period, and also that the balance sheets are in accordance with the books. The disposition of any general ledger assets and liabilities that may have been scrapped, sold, written off, or liquidated during the period under review should be traced and noted in the working papers. Furthermore, a general scrutiny of the general ledger should be made to see that the accounts, if any, that have been opened and closed during the year have no bearing on the company's financial position at the close of the fiscal period.

The verification of a balance sheet should be taken up under the following headings:

Cost of Property.
Inventories.
Accounts Receivable.

Bills Receivable.
Investments.
Cash.
Deferred Charges to Operations.
Capital Stock.
Bonded Debt.
Accounts Payable.
Bills Payable.
Accrued Liabilities.
Contingent Liabilities.
Sinking Funds and Depreciation Reserves.
Surplus at Beginning of Period.
Profit and Loss Account.

The leading schedules to all of the above headings should agree with the figures shown in the balance sheet, and should provide common sense notes on the verification work done, and it should always be remembered that it is from such notes that a principal, to a very large extent, forms his opinion of the manner in which an audit has been conducted. To add to the value and interest of leading schedules, comparisons between periods are always interesting, as are statistics of percentages, such as expenses to sales, inventories to sales, repairs and depreciation to cost of properties, profits to capital stock, etc., etc.

When an audit is being made for the first time, a brief history of the company should be attached to the working papers, showing the date of organization, the State under whose laws the company is incorporated, the consideration for which the capital stock was issued, and notes on the composition of the property and surplus accounts, from the date of organization to that of the beginning of the period to be covered by the audit.

The indexing and filing of working papers appears to receive spasmodic attention by the majority of assistants, but, nevertheless, it is safe to say that in the majority of cases the time spent in carefully arranging and indexing working papers in accordance with the final accounts is fully appreciated when the time comes to take up the audit for another year, as anyone who has followed a careless and slovenly assistant will testify. Furthermore, it is good business practice, as the labor and worry of reconciling working papers with the opening figures at the beginning of an audit is frequently expensive and is not offset by the few hours saved in avoiding this work at the close of an audit.

In periodical annual audits it is essential to have a permanent file in which should be arranged papers that are used in connection with every audit, such as copies of mortgages, notes on royalty agreements, agreements as to bonuses and commissions, notes on system, special matters to be attended to in the audit, etc., etc. If this is not done friction is almost certain to occur with a client, when an assistant, unfamiliar with the work, takes up an audit for the first time, as he is sure to ask questions which have been previously explained by the client, and the answers to which should have been noted in the permanent file.

COST OF PROPERTY:

In preparing the leading schedules for the accounts grouped under this heading, such as real estate, buildings, plant, machinery, etc., the balances at the beginning of the period, the additions or deductions to the accounts during the year and the balances at the end of the period should be shown.

The total of the balances at the beginning of the period should agree with the cost of property figures shown in the balance sheet at that date, and the balances at the end of the period with the amount shown in the balance sheet that is being audited. The charges entering into the additions should be verified in detail and in this connection the following notes may be of value:

(1) Authorizations for the expenditures made during the year should be examined, and where the costs of the additions have overrun the sums authorized inquiries should be made in regard thereto. The authorizations should show the accounts to which the expenditures are chargeable, the amounts thereof, the approvals of the comptroller and manager, and descriptions of the

jobs. When the authorizations are not specific as to the work done the actual additions should, if possible, be inspected.

(2) The auditor should satisfy himself before approving additions that they were made with the object of increasing the earning capacity of the plant, and that they are not of the nature of either renewals or improvements, and in this connection changes in the production and capacity of the plant should receive consideration.

(3) To verify the pay-roll and store and supply charges to jobs, one or two pay-roll distribution reports should be examined in detail, and also one or two storehouse reports. In cases where large purchases have been made from outside parties for capital construction work the vouchers therefor should be examined and the usual precautions taken to see that they are properly approved for the receipt of materials, prices, etc.

(4) For purchases of real estate the title deeds should be examined together with the vouchers, and it should be seen that the deeds have been properly recorded.

(5) While it may be considered permissible to make a charge for factory burden to additions to property, it cannot be deemed conservative business practice, inasmuch as the probabilities are that the overhead charges of a plant will not be decreased to any material extent, even although additions are not under way, and, therefore, the absorption of part of these charges in cost of properties when additions are in progress has the effect of reducing the operating costs as compared with months in which no construction work is under way.

(6) Construction work in progress at the end of the fiscal period should be shown in the balance sheet under the heading of cost of properties, and not as part of the inventories.

(7) The auditor should inquire as to whether any instalments are due on account of construction work in progress which is being carried out by outside parties, and if so, the liabilities for these instalments should

be included in the balance sheet, as they may have a direct bearing on the amount of available cash on hand.

(8) When a company uses leasehold properties the leases should be examined and notes made of the periods covered, so that it may be seen that improvements, etc., on such properties are written off over the periods covered by the leases.

The treatment of good-will, patent rights, patterns, molds, tools, dies, jigs, etc., varies so much with each particular class of business that it would not serve any good purpose to discuss them herein.

INVENTORIES:

Inasmuch as the accuracy of the profit and loss account is absolutely dependent upon the accuracy of the inventories of merchandise at the beginning and end of the period under review, this part of the verification should receive special attention in an audit. Furthermore, when a balance sheet audit is being made for the first time, the inventory at the beginning of the period should receive as much consideration as that at the end, and the auditor should take every precaution to satisfy himself that both inventories were taken on the same basis.

The principal schedule supporting the inventories should show a comparison between the inventory at the end of the fiscal period and that at the beginning, arranged under suitable main headings, and a short description should be given of the actual verification work done.

The following notes will be of value in outlining a suitable programme of audit for inventories:

(1) A thorough test of the accuracy of the footings and extensions should be made.

(2) The inventories should be compared with the stores ledger, work in progress ledgers and finished product records as to quantities, prices and values.

(3) Inquiries should be made as to the number of times the quantities on hand, as shown by the stores and finished product ledgers, have been compared with actual quantities on hand during the year. Unless they have been compared at least twice, the accuracy of the quantities shown by the ledgers should not be accepted without careful investigation.

(4) A satisfactory verification of quantities in the case of a company that does not operate a cost system is almost impossible and the auditor frequently has to be satisfied with a certificate from responsible officials, but in addition to a certificate, the auditor should carefully test the typewritten inventory sheets with the rough sheets from which they were compiled, and with the tickets, cards or sheets that show the original counts.

(5) When the cost system of a company does not form part of the financial accounting scheme there is always a possibility that orders might be completed and billed and not taken out of the work in progress records. Especially is this the case when reliance is placed on such records to the extent that a physical inventory is not taken at the end of the period to verify the information shown therein. In these cases the sales for the month preceding the close of the fiscal year should be carefully compared with the orders in progress, as shown by the inventory, to see that nothing that has been shipped is included in the inventory in error.

(6) As a check against obsolete stock being carried in the inventory in error, the detailed records for stores, supplies, work in progress and finished products should be examined and a list prepared of inactive accounts, which should be discussed with the company's officials and satisfactory explanations obtained.

(7) The inventories should be valued at cost or market prices, whichever are the lower at the date of the balance sheet.

(8) It will generally be found that inventories are valued at the average prices of raw materials and supplies on hand at the end of the period. These prices should, however, be compared with the latest invoices in

order to verify the fact that they are not in excess of the latest cost prices, and also with the trade papers, to see that they are not in excess of market values.

(9) In verifying the prices at which the work in progress is included in the inventory, a general examination and test of the cost system in force is the best means of doing this work satisfactorily. Very few points of principle, as a rule, arise in connection with the distribution of raw materials, stores and pay-roll, but the distribution of burden is one that should receive careful consideration; the main points to be kept in view being:

(a) That neither selling expenses, interest charges nor administrative expenses are included in the factory burden.

(b) That the burden is distributed over the various departments, shops and commodities on a fair and equitable basis.

(10) No profit should be included in the price of finished products, and the valuations should be based upon material, labor and factory burden costs. The price lists should be examined to see that the cost prices of finished products are below the selling prices after allowing for trade discounts, and if they are not a reserve should be set up for this manufacturing loss.

(11) A certificate should be obtained from the officials of the company certifying to their belief in the accuracy of the inventories, and stating that neither obsolete nor unsaleable stock is included therein.

(12) A careful analysis should always be made of the inventory adjustment account, as no matter how scientific a system of factory accounting may be, adjustments frequently require to be made for prices and for discrepancies occurring between the actual quantities of stocks on hand and those shown by the books. Burden rates also require frequent adjustment. Such differences in lieu of a better place to include them are usually brought together in an "Inventory Adjustment Account;" the balance at the debit or credit of this account at the end of each month being transferred to profit and

loss. It will be readily appreciated that a careful examination of this account will reveal the weaknesses of the system, and will probably provide information that may be of material value in deciding upon the accuracy of the inventory as a whole.

(13) The receiving records should be examined for the two weeks previous to the close of the fiscal year, so that the auditor may satisfy himself that all materials received during that time have been duly included in the inventory and the corresponding liabilities taken up therefor.

(14) In the case of a company whose cost system does not form part of the accounting scheme, the sales records for the last two or three weeks of the fiscal period should be examined to verify the fact that no billed goods have been included in the inventory.

(15) In the case of companies manufacturing large contracts it is frequently found necessary to make partial shipments thereof. The question then arises as to whether it is permissible to take up profits on these partial shipments. As a general rule it may be stated that no profits should be taken up on partial shipments, inasmuch as the actual cost thereof is not known until the order is completed, and while it may be estimated that a profit will ultimately be made, yet conditions such as strikes, delays in delivering material, etc., cannot be definitely foreshadowed. In cases where profits are included on partial shipments full details of such transactions should be included in the working papers and brought to the notice of the principal in charge of the work.

(16) The selling prices for contract work in progress should be ascertained from the contracts and, if necessary, reserves should be established for manufacturing losses on contracts in progress.

(17) If a company has discontinued the manufacture of any of its standard products during the year the inventory of such products should be carefully scrutinized and, if unsaleable, the amount should be written off.

(18) The inventory should be scrutinized to see that no machinery or other material that has been charged

to plant is included therein. This remark would only apply to companies that do not operate balancing cost systems.

(19) Partial deliveries received on account of purchase contracts should be verified from certificates from the contractors, both as to quantities and values.

(20) Advance payments on account of purchase contracts for future deliveries should be shown under a separate heading in the balance sheet.

(21) It is not customary to deduct cash discounts from the inventory, but this should be done when it is a trade practice to do so.

ACCOUNTS RECEIVABLE:

The bookkeepers of the accounts receivable ledgers should be asked to draw off lists of the open balances at the end of the fiscal period, and distributions of the total columns should be shown on the lists according to the age of the accounts, e. g., past due, outstanding for sixty days, outstanding for thirty days, and incurred during last month of fiscal period. The accounts paid since the close of the fiscal year should be noted on the lists by the assistant examining the accounts, as payment is the best proof that an account was good at the date of the audit.

The totals of the lists of outstanding accounts should agree with the controlling account in the general ledger. When credit balances appear on customers' accounts they should be included under the heading of accounts payable in the balance sheet of the company and not treated as a deduction from the amount of the accounts receivable, and in the same manner debit balances on the accounts payable ledgers should be treated as accounts receivable.

The lists should be footed and compared in detail with the customers' ledgers.

The composition of outstanding balances should always be examined, as it frequently happens that while a customer may be making regular payments on his account, old items are being carried forward which have been in dispute for a considerable period of time.

Trade discounts allowed by the company should be inquired into, and if they have been included in the accounts receivable a reserve therefor should be set up in the balance sheet.

Accounts which are past due should be taken up with the credit department and the correspondence with the customers examined, so that the auditor may form an opinion of the worth of the accounts and satisfy himself that the reserve for bad and doubtful accounts set up by the company is sufficient.

Inquiries should be made regarding customers' claims for reductions in prices and for rebates and allowances on account of defective materials, so that it may be seen that a sufficient reserve has been established therefor. In large corporations there is generally a claim department which attends to this part of the work.

In large concerns the system of accounting is generally so arranged that it would be almost impossible for accounts to be paid and not credited on the accounts receivable ledgers, but in small companies with imperfect systems such occurrences are quite possible, so much so in fact that it is generally admitted that the risk of cash defalcations decreases in proportion to an increase in bookkeeping incidental to an increase in business.

When it is deemed advisable to circularize the customers in regard to the open balances on their accounts, the auditor should see the circulars mailed after comparing them with the lists of outstanding accounts. The greatest care should be exercised in this part of the work so that no unscrupulous person may have an opportunity to extract circulars addressed to customers between the hours they are compared with the lists and mailed. The envelopes for replies sent with the circulars should be addressed either to the auditor's office or to a post-office box.

The auditor should satisfy himself that the bad debts written off have been duly authorized by responsible officials, and the smaller the accounting force the more important this is.

Accounts due from directors, officers and employees should be stated in the balance sheet separately and not included as trade accounts.

Advance payments on account of construction work and other extraordinary items included in the accounts receivable ledgers should be distributed under their proper headings in the balance sheet.

BILLS RECEIVABLE:

A list of the bills receivable outstanding at the end of the fiscal period should be prepared showing the dates the bills are made, the customers' names, the due dates, the amounts of the bills and the interest, if any, contained in the bills.

The outstanding bills should be carefully examined with the bills receivable book, and with the list prepared by or produced to the auditor, the due dates and the dates of making the bills being carefully checked, and when bills have been renewed the original dates should be recorded in the working papers. When bills have been paid since the close of the fiscal year, the cash should be traced into the books of the company, and when they are in the hands of attorneys or bankers for collection certificates should be received from the depositaries. Bills receivable should, if possible, be examined at the close of business on the last day of the fiscal period to avoid the work of tracing bills paid since the close of the year, which becomes necessary when they are examined subsequent to the date of the balance sheet.

The auditor should never be put off with excuses for not producing bills. In cases where irregularities are suspected lists of discounted bills not matured at the date of the audit should be obtained from the banks, as bills which have been received for accounts receivable may have been discounted by a dishonest treasurer, and in some cases not even recorded as bills on the books.

When bills receivable are discounted by banks before their due dates the company has a contingent liability therefor which should be noted in the balance sheet.

It is generally not considered conservative business policy to take up accrued interest on bills receivable as an asset, as the very fact of a customer granting a bill generally signifies his lack of current funds.

The value of collateral held for bills should be ascertained, as it frequently happens that the value of the collateral is the true worth of the bill.

Bills due by officials and employees should in most cases be stated separately from customers' bills in the balance sheet.

If the accounts receivable are circularized the same procedure should be adopted for the bills receivable.

INVESTMENTS:

A list of investments should be prepared showing:

(1) The dates of purchases.
(2) Descriptions of the investments.
(3) Par value of the investments.
(4) The denomination of the shares.
(5) The number of shares or bonds owned.
(6) The total capital stock of the various companies.
(7) The amounts paid for the investments.
(8) The interests and dividends received.
(9) The market values of the investments.
(10) The surplus or deficit shown by the balance sheets of the companies where no market quotations are available.
(11) Adjustments recommended.

Where the market values of securities are less than the book values the latter should be brought into accord with the former or the necessary reserve provided.

The securities for all investments should be carefully examined and it should be seen either that the certificates are made out in favor of the company, or that they are endorsed or accompanied by powers of attorney when they are in the names of individuals.

The auditor should endeavor to examine the investments and securities either at the close of business on the last day of the fiscal period or during the subsequent day, as it is more satisfactory to see actual securities than to verify cash receipts and other evidence therefor after the close of the fiscal period.

Coupons on bonds should be examined to see that they are intact subsequent to the previous interest payment date.

The investment schedule should show that the total interest and dividends receivable by the company has been duly accounted for; the income from investments shown in the profit and loss account should be in accord with this schedule.

When market quotations cannot be obtained for investments, the balance sheets of the companies in which investments are held should be examined so that the auditor may form an idea of their values.

In verifying purchases of stock exchange securities the brokers' notes should in all cases be examined in connection wtih the verification of the purchase prices.

Investments in deeds and mortgages should be supported by both the mortgages and insurance policies, and, furthermore, it should be seen that all assessed taxes on the properties have been duly paid.

CASH:

If possible, the cash on hand should be counted after banking hours on the last day of the fiscal period, and the amount thereof, together with the cash stated to be in bank, reconciled with that shown by the cash book. The cash, bills receivable and investments should be examined on the same day, so as to make it impossible for a treasurer to make up a shortage in one asset by withdrawing negotiable funds temporarily from another.

In counting the cash on hand the auditor should see that all customers' checks produced to him as part of the cash balance have been duly entered in the cash book prior to the close of the period and should note in the working papers the dates and descriptions of such checks, and also the dates and descriptions of all advances made from cash and not recorded on the books. Advances to employees should be strictly investigated and if any are secured by personal checks the auditor should see that the checks are deposited in bank before the close of the audit.

The utmost tact should be exercised by an auditor in counting cash on hand, as so many cashiers resent even the idea of their cash being counted by an auditor, as they seem to think a reflection is thereby cast on their integrity. In such cases the auditor should be careful to explain that the counting of cash is a recognized part of an audit, just as the verification of inventories is, so that the cashier may know that the auditor is acting in accordance with established business practice.

Certificates should be obtained from the banks in which cash is deposited, and these should be addressed to the firm direct. The balances as shown by the certificates should be reconciled with those shown on either the cash book, the check book stubs or bank registers, after taking into consideration outstanding checks.

In verifying the outstanding checks a comparison of the outstanding checks produced by the company with those listed on a reconciliation statement prepared and submitted by the company's accountant is not sufficient, as it is necessary to prove that no other checks entered in the cash book prior to the closing date were not also unpaid at that date. This would not be disclosed by merely comparing the outstanding checks with the reconciliation statement.

There is only one safe and satisfactory method of proving the accuracy of the outstanding checks, and that is to compare the credit side of the cash book from the last day of the fiscal period backward, item by item, with the checks returned from the bank for such period as may be necessary to account for all current outstandings. Any old checks not yet cashed by banks should be made the subject of special inquiry. When this work is completed a list of the outstanding checks so ascertained should be prepared, showing the dates of the checks and compared with the actual checks returned from the bank at a later date, and any not so returned should be specially investigated.

Special care is necessary to see that no checks for cash purposes are drawn at the close of the period and entered in the next period. Such a practice would enable a dishonest cashier to cash the check so drawn through an outside source on the last day of the period, knowing that it would not appear in the bank account until a later date. By omitting this check from the cash book and from the list of outstandings he could make up a shortage temporarily.

Where the currency and bank transactions are kept together in the cash book and the auditor does not count the cash until a date subsequent to the close of the fiscal year he should, in addition to verifying the bank balances as of the close of the year, verify them as of the date of the count of cash. This is absolutely essential when it is considered that although the cash on hand—which only forms part of the balance—at the date of the count is in order, it does not follow that the total cash is correct.

When receipts are shown in the cash book as being deposited in bank on the last day of the fiscal period, but are included in the reconciliation statement on account of their not being paid into bank until the next day, the auditor should obtain letters from the banks acknowledging such deposits.

So as to guard against manipulation in transfers between banks at the end of a period, the deposits shown in the pass books should be checked in detail for the last two or three days of the fiscal period from the books to prove that they were composed of bona fide checks and that no check drawn by the company was deposited in a bank account without being credited to the bank on which it was drawn prior to the close of the fiscal period.

So that the auditor may satisfy himself that deposits are promptly made in bank each day, and that the same checks are paid into bank as are received, it is advisable to call for a number of deposit slips and compare them with the receipts as shown by the cash book for the days in which the deposits are made. This check might not, however, discover "over-lapping," inasmuch as a cashier could make out one slip for the bank and make the duplicate to correspond with his cash book. Of course, if the auditor suspects anything is wrong, he can always obtain the original deposit slips from the banks for verification.

When the practice of a company is to pay all of its cash receipts into bank, they should be compared and reconciled with the total deposits, as shown by the bank books, and similarly the disbursements should be reconciled with the total checks drawn.

A thorough examination of the accounting system and methods in force for recording cash is very essential, and it should always be remembered that when three or four people are involved in cash transactions before they are finally recorded in the ledger of the company, there is less chance of irregularities occurring than when one person has charge of the cash book and ledgers.

Outstanding checks not examined at an audit on account of their not having been returned by the banks should be called for and traced into the cash book at the beginning of the next audit.

DEFERRED CHARGES TO OPERATIONS:

Under this heading in the balance sheet are usually grouped such items as unexpired insurance, bond discounts applicable to a future period, prepaid royalties, experimental charges, etc. After the clerical accuracy of the deferred charges has been verified the auditor should satisfy himself that they are properly carried forward to future operations.

Wherever possible, documentary proof should be produced in support of the items carried forward, as, for example, with unexpired insurance the policies should be examined to verify the dates of expiration, the amounts covered, and the proportion of the premiums carried forward;

with royalties the agreements should be examined; with experimental charges the vouchers and particulars of the work done should be looked into; etc., etc.

The examination of the deferred charges will usually furnish the auditor with interesting information in regard to the accounts of the company as, e. g.:

(1) The verification of experimental charges carried forward will generally furnish valuable information as to the production and future policy of the company.

(2) Royalty vouchers will generally furnish a check on the production of mines.

(3) An examination of the insurance policies will show if the properties are mortgaged or covered by lien, and thus be an additional verification of the liability for mortgages on real estate, buildings, etc., shown in the balance sheet.

(4) The assets covered by insurance will be ascertained and, if any omissions are discovered, they should be mentioned to the client.

CAPITAL STOCK:

As a rule trust companies are the transfer agents for the capital stock of large corporations, and for verification purposes it is sufficient to obtain letters from them certifying to the capital stock outstanding.

It is essential in the case of companies with cumulative preferred stocks outstanding to make a note in the balance sheet of dividends accrued but not declared.

Where companies issue their own stock, the stock registers and stock certificate books should be examined and compared with the lists of outstanding stockholders.

BONDED DEBT:

A copy of the mortgage hypothecating the assets of a company to the trustees for the bondholders should be examined and the terms thereof noted. The amount of the bonds registered, issued, and in treasury, rate of interest, and the duration of the bonds, should be shown on the face of the balance sheet. A certificate should be obtained from the trust company certifying to the amount of bonds outstanding, etc., as verification of the liability in the balance sheet. The interest on the bonds outstanding, shown in the balance sheet, should be calculated and reconciled with the interest on bonds, as shown in the income account.

Sinking fund provisions in mortgages should be carefully noted and care taken that they are given effect to in the accounts of the company.

Bonds redeemed and cancelled during the year should either be examined or a cremation certificate received therefor from the trustees.

Mortgages frequently stipulate that the current assets must be maintained at a certain amount in excess of the current liabilities and the auditor should familiarize himself with such matters and any other stipulation in regard to the accounts, or an audit thereof, that may be referred to in the trust deed.

ACCOUNTS PAYABLE:

This liability is easily verified in companies with modern voucher systems, as all liabilities are then included in the books when incurred. Care should be taken, however, to see that all goods received on the last day of the fiscal period, as shown by the receiving records, and also all goods that were in transit and belonged to the company on that date are included as liabilities, and the corresponding assets taken up in inventories. The argument is frequently advanced that this test is unnecessary, inasmuch as it does not make any difference if an equal amount is omitted from the inventories on the one side of the balance sheet and from the accounts payable on the other, but the argument is fallacious when it is remembered that an increase in the accounts payable may have a very important bearing on the financial position of a company if the cash on hand is small.

Monthly charges outstanding can usually be ascertained by a comparison of the expenses of the last month of the fiscal period with previous months, and of those of the year with the previous year. The voucher record should, however, be examined for the months subsequent to the close of the fiscal year, in case any expenses included therein are applicable to the fiscal year under audit.

When a first-class voucher system is not in operation the auditor will require to take additional precautions to satisfy himself that all liabilities are included in the accounts, among which may be mentioned:

(1) Payments made in the months subsequent to the date of the fiscal period as shown by the cash book should be carefully scrutinized to see that none of them are applicable to the period under review.

(2) The file of bills not vouchered should be examined to see that none are applicable to the period under audit.

(3) A careful perusal of the minutes may further assist the auditor in determining liabilities.

As an additional precaution against the omission of liabilities, certificates should be obtained from the comptroller and treasurer stating that all outstanding liabilities for purchases and expenses have been included in the accounts of the period under review. In many cases it is also advisable to obtain a certificate from the president stating that all liabilities for legal claims, infringements of patents, claims for damages, bank loans, etc., have been included, as he may be the only executive officer of the company to know the extent of such obligations.

When a company has large purchase contracts in force for future deliveries, they should be examined as, if the contract prices are greater than market prices, it might be necessary to set up a reserve for this loss.

BILLS PAYABLE:

The outstanding bills and loans should be compared with the bills payable book, and the schedule therefor in the working papers should show the dates of making the notes, the dates they fall due, the names of creditors, the collateral hypothecated, additional endorsers, the amounts, the interest accrued, etc. Notations should be made in the working papers of any notes that may have been renewed, as information of this nature furnishes a guide to the state of a company's credit.

When it is customary for a company to carry large loans with its bankers, it is advisable to add to the bank certificate circulars, requests for lists of loans made by the various banks. These lists when received should be checked against the loans shown on the company's books and approved in the minutes of the company.

Inasmuch as a note payable is a negotiable instrument, it is advisable to see that all of those paid during the year under audit have been properly discharged.

Careful attention should be given to the collateral deposited for loans, as should any of the company's assets be hypothecated, the fact should in most cases be brought out in the balance sheet.

ACCRUED LIABILITIES:

Frequently companies make a separate heading of "Accrued Liabilities" in their balance sheets for such items as accrued wages, taxes, interest, etc. The verification of such items can be accurately made from the books and records as, for example, if a fiscal year ends on December 31st and the wages have been paid up to and including the week ending December 28th, the liability for the three days to the 31st can be definitely ascertained from the payroll for the week ending January 4th. In the same manner, the amount of accrued taxes can be ascertained from an examination of the receipts for the latest payments. In some States the periods for which the taxes are paid is not shown on the face of the receipts, and in such cases it may be necessary to make inquiries of the Tax Commissioners as to the periods covered.

Accrued interest on outstanding bonds and bills payable is a definite liability and does not call for any special comment.

CONTINGENT LIABILITIES:

Contingent liabilities should always be shown on a balance sheet either by means of foot-notes or by referring to them in the body of the balance sheet, without extending the amount in the money column. Notes receivable discounted, but not due, come under this heading, also notes endorsed for outside parties, etc.

SINKING FUNDS AND DEPRECIATION RESERVES, ETC.:

Provisions for sinking fund reserves for the redemption of bonds are based on definite facts recorded in the mortgages. When these reserves are provided out of earnings, the question as to whether they do not form a sufficient provision for depreciation should receive consideration.

Sinking fund reserves for the extinguishment of minerals are more or less of a definite nature, inasmuch as estimates can frequently be made of the quantities of the minerals in the ground, and a fixed sum per ton charged to operations as the minerals are mined to provide for the capital investment after the mine is exhausted.

Reserves for the relining of blast furnaces and the rebuilding of open hearth furnaces are definite and can be decided upon from past experience, as can also other provisions that are specifically ear-marked, such as reserves for contingencies, accident insurance, idle expenses, etc.

The adequacy of the amount of reserve for depreciation and accrued renewals is generally one of the most difficult matters to pass upon in a balance sheet audit. The theory, of course, is that a sufficient sum ought to be provided out of earnings each year to take care of obsolescence, accrued renewals, and that depreciation of the properties which will never be made good. Among the more usual methods of calculating these reserves may be mentioned:

(1) The setting aside of a round sum each month based on a percentage of the capital assets.

(2) Basing the monthly provision on either the production, sales, or pay-roll.

(3) Waiting until the annual earnings are known before deciding upon the provision for depreciation.

The amount of the depreciation charge each month should vary with the capacity at which the plants are operated, as it is reasonable to suppose that depreciation is not so great when plants are operating at half capacity as it is when they are full.

Expenditures for renewals and extraordinary repairs which occur periodically, and are not applicable to the period in which they are made good, should be charged to these reserves. The expenditures should be supported by authorizations in the same manner as has already been described for additions to properties. When property is either dismantled or abandoned, the difference between the cost price and the scrap value should be charged to the reserves.

Although depreciation and renewal funds are frequently set up each month on a unit basis, yet the amount of the annual provision must first of all be decided upon on a basis of percentages of the different assets embraced under the heading of cost of properties before the unit rate can be determined. At the best such reserves can only be based upon a system of averages, and there is therefore always much room for differences of opinion and discussion as to the sufficiency of the reserves. However, it is better to err on the side of an over-provision than to underestimate the reserve.

The practice of charging only the proportion of the loss on dismantled machinery for the period it has been in use against the depreciation reserve and the balance of the loss against profit and loss account should not be encouraged, as it would appear to be better business practice to charge the total loss against the depreciation reserve, as other machines still in use may outlive their estimated lives.

The leading schedule in support of the reserves should show:

(1) The balances at the beginning of the fiscal period.

(2) The provisions during the year.

(3) The charges to the reserves.

(4) The balances at the end of the period.

In considering the sufficiency of the reserve for depreciation the total charges during the year for repairs and maintenance should always be ascertained and the percentages of these and of the provision for depreciation to the value of the properties at the beginning of the period should be shown in the working papers, with a comparison of corresponding statistics for previous years.

SURPLUS AT BEGINNING OF PERIOD:

This item represents the accumulated profits prior to the beginning of the fiscal period under review, and should be compared with the surplus shown on the balance sheet of the previous year to see that it corresponds, and if it does not, a reconciliation statement should be prepared giving full details of the differences.

When a balance sheet audit is undertaken for the first time the company should be asked to produce a statement of its surplus account from the incorporation of the company to date, as such a schedule forms an excellent history of the company's affairs, and will also disclose any appreciations of real estate, investments, etc., that may have been credited to surplus.

PROFIT AND LOSS ACCOUNT:

The balance of the profit and loss account is usually added to the surplus at the beginning of the period in the balance sheet and the two extended in one amount.

While it would be impracticable in an ordinary balance sheet audit and, at the same time, somewhat useless to make a detailed check of all of the transactions entering into the composition of the profit and loss account, there are certain main principles to be kept in view which are briefly outlined below:

Sales:

Whenever it is possible the quantities sold should be reconciled with the inventory on hand at the beginning of the period, plus the production during the period, less the inventory on hand at the end of the period. Where the production can be calculated on a unit basis as, for example, in sugar mills, this is a comparatively easy matter.

Where a good cost and accounting system is in force the sales records will very probably be in good shape, but, nevertheless, the auditor should satisfy himself from the shipping memorandums that the sales books were closed on the last day of the fiscal year, and that no goods shipped after that date are included in the year's transactions.

When an audit is being made for the first time the auditor should satisfy himself that the sales at the beginning of the period were recorded in accordance with the dates of shipments. Such verifications can be made conveniently by a direct comparison of the shipping memorandums with the invoices billed.

Allowances to customers for trade discounts, outward freights, reductions in prices, etc., should be deducted from the sales in the profit and loss account, as the amount of the net sales is the only figure that conveys any meaning to the public.

The future bookings at the close of the fiscal year should be looked into, as a comparison of orders on hand with corresponding periods of other years is always interesting, and furnishes an intelligent auditor with an idea of the company's business outlook.

Manufacturing Cost of Sales:

If the company audited has a good cost system this heading of the profit and loss account will have received consideration in the examination of the cost ledgers in connection with the verification of the inventory. It should be seen, however, that this heading in the printed accounts is not made a dumping ground for charges which would more properly be embraced under the heading of special charges. The composition of the items entering into the manufacturing cost of sales should be traced in totals into the cost ledgers.

Other Income:

Under this heading is usually embraced any income that cannot be considered as coming under the heading of sales, such as rents of dwellings, interest on outside investments, commercial discounts received, less commercial discounts paid, etc. Schedules should be prepared of each item embraced under the caption of other income and the auditor should satisfy himself of their accuracy and of the propriety of including them under this heading.

Selling, General and Administrative Expenses:

These expenses should be compared with similar expenses in the previous year. The percentage of these expenses to the total sales should also be worked out, as such statistics often reveal increases and decreases in the expenses as compared with other years which otherwise might not be detected. The expense accounts should be examined to see that no extraordinary credits have been made thereto for the sales of capital assets and for other items which should not be recorded in expense accounts.

Special Charges:

Expenditures that cannot be grouped under the heading of either manufacturing costs, or selling, general and administrative expenses, and are not chargeable to reserve accounts, are usually entered as special charges in printed accounts, and it is unnecessary to comment on such expenses in this memorandum, as the particulars of special charges vary with each business.

EXAMINATION OF ACCOUNTING SYSTEM AND METHODS:

While a balance sheet audit may not be sufficient to reveal all internal irregularites that may have occurred during the period under review, yet a thorough examination of the system may lead the auditor to suggest improvements for internal checks which would preclude the probability of irregularities occurring in the future, as for example:

(1) If it is found that checks are signed by only one officer of the company, it should be suggested that the signature of two officers, at least, should be required.

(2) If invoices are approved for payment by the purchasing agent, both as to quantities and prices, it should be suggested that while it is in order for the purchasing agent to approve the prices, the quantities received should be approved by another party.

(3) If the wages are paid by the clerk who makes out the pay-roll, and if the timekeeping be in the hands of one individual, these matters should be referred to in the auditor's report.

(4) If investments are in the sole custody of any particular officer of the company, it should be pointed out that this is contrary to good business practice.

In conclusion it should be stated that at the finish of a balance sheet audit undertaken for the first time, and on behalf of clients who are unfamiliar with the scope of an audit, it is generally very desirable to furnish clients with a detailed report as well as certified accounts. In addition to discussing the financial position of the company in the report, important defects in the accounting system should be referred to, and a synopsis should be given of the detailed verification work done, so that there may be no misunderstanding in the mind of the client as to the extent of the audit.

J. C. Scobie, July 31, 1913.