represent only a small part of full earning power or which may at times represent more than earning power.

Goodwill in Book Value of Stock. It has been customary in the case of consolidations to charge excesses paid over book value of stock or over book value of assets acquired to goodwill or, at least, to reflect such excesses as goodwill when the consolidated balance sheet is prepared. Have these excesses really any relation to goodwill? If they do not, why should they be charged to goodwill? If not chargeable to goodwill, to what account should they be charged?

When a corporation not involved in a merger or consolidation incidentally purchases stock of another corporation, any excess paid over par or over book value becomes part of the investment cost and is consistently carried on the books as such. No charge, of course, is ever made to goodwill. But, when upon consolidation one corporation purchases the capital stock of another at more than book value, the excess is either immediately treated as goodwill, or at least, it is so treated when a consolidated balance sheet is prepared. Would it not be more accurately descriptive to call this excess either "Premium on Subsidiary Stock" or "Excess over Book Value of Subsidiary Stock"?

Goodwill is proved earning power in excess over normal interest returns on an investment, and it is only indirectly related to book value of stock. A company may have a large surplus (large book value of stock) and yet may have no goodwill and, vice versa, a company may have goodwill and yet have a very limited surplus. For example, a corporation may have earned only 6 per cent on its investment for a long period of years, and may have permitted its earnings to accumulate into a considerable surplus account. That corporation has no goodwill, because goodwill represents earning power in excess of that required to yield a safe return on the investment. On the other hand, a corporation may have earned 15

or 20 per cent on its investment and may have distributed most of its earnings as dividends, because little working capital may have been needed. That corporation would have a very small surplus and yet a very large goodwill.

It is quite evident that no goodwill should be set up when stock is purchased at book value even though it may be considerably higher than par value. Again, stock purchased at a price in excess of the net worth may or may not contain a goodwill element even though it has been the practice among accountants to charge the excess over net worth to goodwill. Book value of stock is fixed by the sum of the capital stock and surplus, and when set up by the purchasing corporation as the cost of its investment in a subsidiary corporation it should be "washed out" or eliminated in the preparation of a consolidated balance sheet by being offset against the subsidiary corporation's capital stock, and surplus accounts.

Stock of Subsidiary Purchased Below Book Value. At times, the capital stock of a subsidiary may be purchased at less than book value, and apparently the purchasing corporation has made a profit in the transaction. Accountants have been in the habit of treating such gains as either capital surplus of the consolidation or, if any goodwill has been set up anywhere in the consolidation, as a reduction of that goodwill. There is hardly any objection to be raised if the excess values acquired are credited to capital surplus provided the values are real and beyond question, but why any goodwill, which may be found anywhere in the consolidation, should be reduced on account of such a gain is a rather difficult proposition to understand. Why should any goodwill legitimately acquired and properly treated on the books become minimized because through business acumen an advantageous purchase of another corporation's capital stock was consummated? If, of course, the purchased subsidiary itself has a goodwill account, the gain on the purchase of its capital stock should be credited against

that specific goodwill or, if some of the tangible assets are found to be overvalued, the credit should be against these; i.e., if no goodwill account is carried.

In this discussion it must be remembered that the capital surplus referred to is capital surplus arising out of the consolidation. The corporation purchasing the capital stock at less than its book value does not make any entries on its books beyond the purchase price of the stock, and this it carries as investment. But in preparing the consolidated balance sheet the net worth of the subsidiary will exceed the investment of the purchasing corporation and it is this difference which is reflected in the consolidated balance sheet.

In an assumed case where $50,000.00 of net worth (capital stock and surplus) has been acquired through the purchase of the subsidiary's capital stock, for $40,000.00, the elimination journal entries, for purposes of consolidated balance-sheet preparation, would be as follows:

Net Worth Subsidiary:		
(Capital Stock and Surplus)	$50,000.00	
To Investment Account—		
(Purchasing Corporation)		$40,000.00
Capital Surplus of Consolidation		10,000.00

If, in some cases, it is found, or there is a suspicion that the assets of the purchased subsidiary are overstated, the difference between the investment account and the net worth of the purchased subsidiary should be credited to a Reserve for Subsidiary Assets Valuation Account rather than to Consolidated Capital Surplus. After the real values are later determined, the Reserve Account can be properly adjusted.

Minority Interests. In effecting consolidations, it is not always possible for the purchasing corporation to acquire all the capital stock of the subsidiaries. It may be able to obtain a majority interest only, in which event so-called "minority stockholders" will still be members of

the subsidiary corporations. The interests of such minority stockholders must naturally be protected, and their proportionate interest in the surplus of the subsidiary must be displayed in the consolidated balance sheet. These minority stockholders are also entitled to their proportionate share of profits made by the subsidiary after consolidation, because the ownership of the majority stock by another corporation does not affect the status of the subsidiary as a corporation. There has been merely a substitution of stockholders, and no change in corporate status or the rights of stockholders has occurred.

If the subsidiary company had a deficit instead of a surplus, the minority stockholders would, of course, have to bear their proportionate share thereof which might be shown as a partial impairment of their capital stock interests. The deficit to be absorbed by the purchasing corporation, assuming that net worth of the subsidiary was the basis of the stock purchase, would appear in the investment account of the purchasing corporation, which would be eliminated in the preparation of the consolidated balance sheet.

Intercompany Accounting after Consolidation. Consolidations are quite generally effected in order to bring into proper juxtaposition the operating factors of closely related businesses or industries, and to produce various economies through the elimination of certain personnel groups. Through consolidation with other corporations, a manufacturer, for example, may be able to gain control over his essential raw materials or he may be able to eliminate troublesome competition. In forming consolidations it is, therefore, quite necessary to observe laws which prohibit mergers that are in restraint of trade.

Consolidations again may be primarily economy instruments. One executive group instead of many may be able to administer the affairs of the consolidated business, or one sales force may be able to market all the commodities of the group of corporations where for-

merly each corporation had its own sales force. More economical means of manufacture and distribution may be devised through processes of functional redistribution. In other words, the formerly independent corporations after consolidation become much like operating departments of a single business and these they virtually are. The transactions between consolidated companies are, therefore, quite logically treated like interdepartmental operations, that is, as operations between integral units of a single business.

Intercompany relations express themselves most often through the processes of sale and purchase, that is, the sales made by one company become the purchases of another in the consolidation. This is, of course, equivalent to a transfer of merchandise between departmental units, that is, it must be regarded as an internal transaction not affecting the outside world. Such intercompany sales must therefore be eliminated in a consolidated profit and loss statement. If not eliminated such sales would be again repeated by the subsidiary which had made the purchases and which would sell the commodities to outside customers.

If, for example, Corporation A sold $50,000.00 of its commodities to Corporation B (these corporations being consolidated), Corporation A would include this amount in its sales and yet Corporation B would sell these same commodities to outsiders in either their original form or in a converted form. Consequently only the sales to outsiders must be considered as sales when dealing with the units consolidated. The company making the purchases from an affiliated company must at the end of a fiscal period, when a consolidated statement is being prepared, determine the amount of its inventory which represents such purchases and must eliminate therefrom the percentage of profit and reduce it to cost or market, whichever is lower, that is to the cost or market figure used as a basis in valuing the inventory of the selling

corporation. By this process that portion of the inventory of the purchasing corporation will assume the status of an extended or transferred inventory of the selling corporation.

In the balance sheets of affiliated corporations the transactions of sales and purchases between the corporations are expressed by accounts receivable and accounts payable, respectively. From the viewpoint of the consolidation, these accounts do not exist because of the very simple principle that one cannot owe money to oneself. Such accounts must, therefore, be eliminated in the process of preparing the consolidated balance sheet. The same procedure would be applicable to loans made between affiliated companies and the interest paid on such loans would be eliminated both as expense and as income. In preparing the consolidated surplus account, intercompany dividends would also disappear because the dividends received by one corporation would be offset by those which were paid by another. In the consolidated balance sheet dividends payable would be set off against dividends receivable, if these were intercompany items.

Subsidiary Holding Company. It is sometimes found in consolidations that a subsidiary, controlled by a holding company, is itself a holding company and controls a number of other corporations. If, in such a case, the subsidiary holding company owns all the capital stock of its subsidiaries, no difficulties will be encountered in preparing the general consolidated statements. It may be, however, that such a subsidiary holding company may own a majority interest only in its subsidiaries and that in turn the general holding company will not own all of the capital stock of the subsidiary holding company. Under such conditions great care must be exercised to reflect properly the various minority interests.

Considerable accounting detail has been injected into this discussion, because all of the factors projected must

be carefully observed when an audit of a consolidation is made. In fact, the preparation of consolidated balance sheets and operating statements, coming as it does at the end of a fiscal period, has become largely the task of public accountants. In this case, therefore, the accounting principles are essentially auditing principles, because the preparation of the statements is in reality an auditing process.

TEST YOURSELF ON ESSENTIAL POINTS

1. Define a consolidated balance sheet. (From American Institute Examination.)

2. Outline three methods of effecting a consolidation.

3. What is the purpose of a company organized to hold stock in subsidiaries, without engaging in the actual operations of the business?

4. In the process of consolidating several competing establishments, Corporation A, the holding company, acquires $98,000.00 out of a total of $100,000.00 of the capital stock of Company B. At the time of the purchase the balance sheet of Company B showed surplus and undivided profits of $50,000.00. Company A bought the stock of B at 200 per cent. Almost immediately after the purchase Company B paid a cash dividend of 25 per cent. In what ways would the payment of this dividend affect (a) the balance sheet of B; (b) the balance sheet of A; (c) the consolidated balance sheet of A and its subsidiary companies? Give reasons for your answer. (From American Institute Examination.)

5. Explain why intercompany sales should be eliminated in the presentation of the consolidated profit and loss statement.

Chapter XXVI

AUDIT OF SPECIAL BUSINESS TYPES

PUBLIC-SERVICE COMPANIES

Governmental control and regulation of public service companies—Railroads—Passenger revenue—Freight revenue—Electric roads—Interurban—Electric railways—Depreciation—Revenue.

Governmental Control and Regulation. Ever since the creation of the Interstate Commerce Commission in 1887, the Government control and regulation of public utilities have greatly increased, not through the larger powers given the Commission in 1906, but as much by the growth of state regulation of corporations of this kind operating purely within state limits. The various amendments made to the Interstate Commerce Act extended the powers of the Commission so that now steam railroads, express companies, sleeping-car companies, certain water carriers and pipe lines, electric railways, telephone companies, and other concerns whose activities are interstate are under Commission rules.

Wisconsin, New York, Massachusetts, Illinois, Maryland, and, in fact, in one form or another all of the states in the United States now have public-service commissions which regulate rates, provide classification of accounts, grant franchises, pass upon bond or stock issues, and control to a greater or less degree the internal operations of the various state public utilities.

In auditing the accounts of any public-utility company, the auditor serves not only the corporation, but also stands between the corporation and the public. It becomes his duty to see that the corporation carries out fully the provisions of state or national laws. If he has not already done so, it is imperative that he become fully acquainted with the laws and commission rules affecting the particular case under investigation. If care-

less at all, he is not performing his duty as a professional man or as a citizen. He should reveal all acts in any way contrary to law or public welfare.

RAILROADS

The latest classification of accounts laid down by the Interstate Commerce Commission for steam railroads is sound from the public accountant's point of view. Throughout an audit, therefore, the compliance with classification rules must be checked and every charge to capital or income carefully scrutinized. The verification of income is of equal importance.

Passenger Revenue. The principal income of railroads consists of passenger and freight earnings. Revenue from passenger traffic comes almost entirely through local agency ticket sales. A small amount comes from cash fares collected by conductors. The report of tickets sold by station agents, which reports should indicate ticket numbers and destination, must be accompanied by the cash collections or receipted deposit slips (if local bank accounts are maintained) and should be compared with the canceled tickets turned in subsequently. Such checks are adequately provided in the department of the auditor of receipts. Accordingly, the public accountant may confine his verification to a number of exhaustive tests. The sum of canceled tickets, unused tickets returned for refund, and tickets sold at stations, outstanding at the end of any period, should agree with the station agent's report of tickets sold. Since an audit generally occurs at a time sufficiently subsequent to the close of a period, the uncanceled or outstanding tickets can as a rule be readily verified. They are generally in before the audit is completed. All tickets of whatever description should be numbered consecutively in series, in order that they may be readily accounted for. In fact, this feature may almost be reduced to a ticket inventory basis, the station agent being charged with all tickets issued to him and held accountable for them in his station reports.

The canceled tickets will form the final check on the amounts collected at the stations.

Interline accounting systems must be carefully investigated by the auditor. A company collects a great many tickets issued by other roads and, of course, issues many tickets collected by other roads. In the one instance it has a claim, in the other it has a liability. The station agent's report should therefore indicate all tickets sold to destinations on other lines and these should be accompanied by the duplicates, or other evidences thereof, so that the home office may at once record its liability to the other road. Payments for interline claims should not be made until the canceled tickets have been returned and checked against the station agent's reports and duplicates. The auditor should verify all outstanding claims against other lines by requesting their certificates; he should verify the amounts due other roads in the same way.

Freight Revenue. The income from freight traffic is the largest item of revenue. This account is to be constructed, as in the case of passenger income, from the reports of station agents indicating the freight received and the freight forwarded. These reports must be tied up with the cash collections, the way bills, and the interline references. The auditor may not have to check all these reports in detail, but he must examine the system of internal check thoroughly, so as to make sure that an effective control is maintained by the head office over all the station agents and any others handling the funds of the company. The agent's accounts ought periodically to be audited by traveling auditors or by professional accountants. Uncollected items in the agents' accounts deserve very close scrutiny, and any old or suspicious looking balances carried by the agents must be run down. All accounts with agents per general books must be reconciled with their reports.

In analyzing or vouching the disbursements, the most vital feature to be observed by the auditor is the correct-

ness of the charges with reference to Capital or Operating accounts. Charging construction costs to Maintenance will inflate expenses and consequently profits will appear small and secret reserves will result. At the same time such a condition might lead to agitation for rate increases which, if granted, would fleece the public. The error of charging maintenance expense to Capital would inflate profits and would be damaging to the stockholders. All capital and construction accounts should, therefore, be carefully analyzed by the auditor. On most roads, there are specific construction departments which are separate from the divisions engaged in maintenance work. This separation of functions has considerably improved the situation from the accountant's view.

ELECTRIC ROADS

Electric roads are readily classified as follows:

1. Interurban lines.
2. City street railways.

Interurban Lines. The accounts of the two vary considerably and their sources of revenue are quite different. Street railways come under the supervision of city laws and state commissions. Interurban roads may come under both of these, and if they carry on interstate traffic will be subject to Interstate Commerce Commission regulations. The activities of interurban lines are coming to resemble more and more those of the steam roads. The only marked differences are in the motive power, the rolling stock, and the variety of sources of income.

The interurban lines carry freight, they act as agents for the express companies, they carry passengers, and maintain regular stations for the sale of tickets and the convenience of the public. Besides, the interurban lines in many localities own and operate amusement parks. They sell electric light and power and obtain revenue from advertising space let in cars. This larger field of

operations perhaps makes the audit of interurban electric roads somewhat more complex than the audit of steam road accounts.

In any audit it will, therefore, be necessary to gain familiarity with the classification of accounts in use and with the accounting system generally. On roads with short runs, where no stations are in use, the income from fares is tabulated from the conductor's traffic sheets. These sheets indicate the cash fares, the tickets, and the passes collected on each run. This same procedure is followed by city railways. The auditor should make a thorough test of the traffic sheets by comparing them with the daily summaries and the cash book entries. Incidentally, this test will also afford a proof of the conductors' and the motormen's pay roll. No names should appear on the pay roll unless there are traffic sheets bearing the same names. Since every conductor is usually accompanied by a motorman, the pay roll for motormen can be checked simultaneously. Traffic sheets should be on hand for every day of the year and any omissions must be thoroughly investigated. Of course, omissions are possible. The line may have broken down, heavy snowfalls may have made traffic impossible, or strikes may have prevented operations.

Receipts from the sale of tickets may be verified more readily than in case of steam roads because there are no interline sales. In many instances, where the tickets are numbered consecutively in series according to destinations, the income can be verified by taking the difference between the first and the last numbers of each series issued and multiplying the result by the rates applicable from point of origin to destination. Such a total check is very effective, and as a rule will be complicated only by tickets in the hands of conductors that are unsold or unaccounted for. However, if daily checks exist on tickets issued to conductors, a reconciliation account can readily be prepared and the income verified.

The income from ticket sales at stations of the larger interurban lines should be verified by the same methods used in the audit of steam-road accounts. Income from freight traffic must also be treated in the same way. Miscellaneous income from amusement parks, car advertising, and the sale of scrap must receive special attention. Much of this income is irregular or seasonal, and it should therefore be thoroughly safeguarded. The income from amusement parks consists, as a rule, of leased privileges which are paid in the form of rent. All the rental contracts must be scrutinized and the income compared therewith. Gate fees are rare in connection with these amusement parks, but, where a road charges admission, the turnstile records or ticket numbers should afford an ample check.

Electric Railway Accounts. Probably the most important feature in the audit of electric-railway accounts is the verification of expenditures, especially with reference to their distribution as between capital and income. Frequently purchases for maintenance and construction are identical and, therefore, it is difficult to distinguish them. Some companies follow the practice of charging all such purchases to a Suspense Account, awaiting an authorized report from the proper department as to the final disposition, that is, as to whether the material was used for repairs and maintenance or for new construction. Some companies maintain fairly well-developed construction cost records, and in such cases the auditor can more readily verify the construction charges.

Where detailed cost records are lacking, the absolute verification of these charges is practically impossible. In such cases very thorough inspection must be made of the contract file, the pay rolls, and whatever stores records are available. A fair total check may be obtained by a comparison of operating expenses per car mile with the same expenses of prior periods. If these expenses decrease considerably, there is justification for suspecting

that operating or maintenance charges have been capitalized. The comparison can then be made in more detail so that the differences may be allocated to certain accounts. An analysis of the latter will generally reveal the errors. The auditor should also give the proper advice with reference to the need for adequate cost records and ledgers. These may be operated at very little expense, and can readily be controlled through the general books.

Depreciation. Proper amounts of depreciation should be provided for all operating property, even though the company may have fallen into the error of thinking that their franchise values increased sufficiently to offset any depreciation. The charge of depreciation into operations and the consequent recovery thereof through revenue is the factor which will procure funds for the rehabilitation of the company's property. The increase in franchise values, even if evident, will never secure these funds unless the franchises are actually sold.

Certain portions of reconstruction charges may be capitalized, even though they might ordinarily be charged against the depreciation reserve. Where the reconstruction actually enhances the revenue producing power, the excess of reconstruction over original cost may rightly be capitalized. It is conservative policy to treat reconstruction of run-down property purchased as a capital investment—especially if the expenditures will produce additional revenue and if proper depreciation is provided and charged against the revenue accruing therefrom.

Quite a number of street railways and interurban lines sell coupon tickets or books which reduce the fare per ride. Tickets sold in quantities are, as a rule, not redeemable. Hence there is little reason for considering the unused tickets as a current liability. Moreover, the outstanding unused tickets would probably be very nearly the same between periods. Consequently a proper check of the tickets sold and of the income derived therefrom

should suffice from an accounting standpoint. Where, however, coupon books are redeemable if not used wholly or in part, the company should at least carry a memorandum account covering the contingent liability. If more elaborate control is desired and it has been found that redemptions are considerable, the coupon books sold should be set up as a liability and the latter account translated into income as the canceled coupons are received.

Income from Advertising. Income from advertising in street cars and stations is, as a rule, easily susceptible of verification, because the advertising spaces are generally sold or leased to advertising agencies for specific amounts under contract. If the company itself rents out advertising space, the contracts should be carefully inspected and the advertising spaces in the cars and stations should be inventoried. Unused spaces should be properly accounted for. As a rule, the advertisers themselves see to it that the spaces they engage have been fully used; therefore an actual inventory of spaces utilized will reveal any irregularities. The revenue should, of course, be checked against the rates.

Damage Suits. Damage Suits against street railways and interurban lines are common, and it becomes the auditor's duty to determine the status of these suits. Proper reserves or liabilities must be provided, the entire expenses of litigation must be ascertained, and, if necessary, the company's attorneys should be interviewed or written to in order to determine the extent of unsettled claims and the fees payable. The larger companies maintain their own legal or claim departments and, in such cases, the departments themselves will yield all necessary information. Threatened suits must be as carefully covered as those actually in litigation. It is advisable, where the practice is not already followed, for the auditor to recommend the establishment of an accident or damage claim reserve account based upon established

percentages of these expenses to operations. The reserve must of course, be ample to meet all ordinary contingencies of this nature.

Test Yourself on Essential Points

1. You are called upon to audit the accounts of a large railroad system. State shortly what its sources of income are, what records you would expect to find containing the details of them, how they are generally summarized in order to bring them on the books of the company, and how you would satisfy yourself of their accuracy. (From American Institute Examination.)

2. How would you proceed to verify the revenue of a street railway company? (From C. P. A. Examination.)

3. A banker wishes to purchase a large portion of the bond issue of a street railway corporation and employs an accountant to examine the accounts:

   (a) What is the information to be given the banker?

   (b) What important accounting matters should be given special attention and how? (From C.P.A. Examination.)

4. If upon investigation you find a large damage suit pending with an electric railway company, how would you as auditor deal with the situation?

Chapter XXVII

AUDIT OF SPECIAL BUSINESS TYPES (Cont'd)

Income of telephone companies—Local service revenue—Income from advertising—Depreciation—Electric light and power companies—Meter records—Sales of appliances—Depreciation—Gas companies—Production and consumption—Water companies.

TELEPHONE COMPANIES

In most of the states, telephone companies have passed under the jurisdiction of public-service commissions. These regulate the rates and the nature of service expected, and in many instances have proposed account classifications. These conditions appreciably facilitate the auditor's work.

The income of telephone companies may be divided into the following classes:

1. Local service revenue.
2. Long-distance calls.
3. Income from investments.
4. Miscellaneous income from rentals of property, sale of scrap, telephone-directory advertising, etc.

A clear distinction should be observed between local-exchange income and long-distance tolls, and the expenses chargeable should be accurately distributed or proportioned between them.

Local Service Revenue. Income from local service is recorded in the contract ledger, which is ruled so as to provided for monthly charges for an entire year. The original charge to a customer is made in this ledger and is often a carbon of the actual bill mailed out to him. The totals are transferred each month to the general ledger controlling accounts for customers' ledger and local service revenue. This form of ledger provides a means of carrying balances forward from month to month, so that a trial balance may readily be taken or verified. It will also show at a glance the current accounts as distin-

guished from the old accounts, thus aiding in the construction of an adequate reserve for doubtful accounts.

The largest expenses by far in telephone companies are salaries and wages. The pay rolls must therefore be thoroughly checked. In large cities the number of switchboard operators alone runs into thousands. The pay rolls for these should be compared with the switchboard requirements in each exchange. Each operator has charge of certain sections only, and a test check of this kind will very readily disclose any padding.

As taxes form a considerable item of expense, the tax bills should be carefully examined. The auditor must also assure himself that the full liability for accrued taxes is included in the books.

Income from Advertising. Income from the classified advertising section of the telephone directory must be verified. In some of the larger cities, where separate classified directories are issued, the whole advertising section is turned over to some advertising agency, the company receiving the income therefrom under contract stipulations. Such contracts must be examined. When the company sells the advertising space itself, the whole revenue may be verified by making an inventory of the advertisements in each issue and multiplying the spaces or insertions by the rates applying to the various kinds of advertising.

The revenue from public pay stations may be accounted for either by checking the call records (or lists of calls received from these stations at the various exchanges) or, where slot boxes are used, by comparing the record of slot-box collections with the call sheets at the receiving exchanges.

Depreciation. The depreciation of telephone property is heavy. For the larger exchanges various state commissions, including the Wisconsin railroad commission, allow an annual depreciation rate of 7 per cent; in the

smaller exchanges a larger rate, ranging from 8 to 10 per cent, is permitted. The auditor should see that the rates recommended by the commission are observed. Unusual charges for damages caused by storms may be partly deferred and should be equitably prorated during the period decided upon. The period of deferment should not be too long drawn out, because damages of this nature are of fairly frequent occurrence.

ELECTRIC LIGHT AND POWER COMPANIES

Production and Revenue. The income of electric power and light companies consists of power, light, and appliance sales. A new feature appears in connection with this type of public service company which has not been discussed before, namely, the manufacturing operations. There is naturally a close relation between current manufactured and current sold, and the two should be reconciled as closely as possible. The enormous quantities of power generated and sold by the electric companies of the large cities make it almost impossible to secure an entire reconciliation between production and consumption. The auditor can, however, make sufficiently exhaustive tests to eliminate to a very large degree the evil of tapping the current. The records of current sold as reported to the general office by the meter-readers should always be compared in totals with the current production.

Records of Meter-Readers. The records of meter-readers are the basis for the charges to consumers, as both the bills and the consumers' ledger are constructed from these records. The better form of ledger, now generally in use, provides one account on a page, instead of the horizontally arranged form where dozens of names appear on one page with the monthly charges and balances carried across the sheet. The one-name-per-page ledger eliminates the necessity of writing up each account at the beginning of each year and may be used for a number of years. The balances per consumers' ledger must

agree with the controlling account and the entries should be compared in a number of instances with the meter-readers' records.

Sales of Appliances. The sales of appliances should be verified through the inventories, that is, on a quantity basis as well as by values. A Perpetual Inventory Account should be kept with all the different types of appliances. The auditor should check the purchases of appliances into the inventory account. He should add these to the beginning inventory, and should deduct from the sum of the two the inventory at the end. This will give at once the quantities of each type of appliance sold, and as the prices charged for these are publicly known or are prominently advertised by the company, no difficulty should be experienced in verifying the total income from this class of sales.

Depreciation. The audit of the manufacturing accounts should receive very special attention and particularly with reference to depreciation of equipment. The rates for depreciation should be high, because the element of obsolescence is quite pronounced. It is commonly known that some of the largest producers of electric power and light have been forced in recent years to throw out an enormous amount of equipment because of its obsolescence. We have been told by a large producer that this was also necessary in order to make a fair profit because of rate regulations which were based upon production costs under the most approved methods.

GAS COMPANIES

The accounts of gas companies are similar to those of an electric company, and the problems confronting the auditor are therefore the same.

Gas Production and Consumption. There are, however, a number of elements peculiar to gas companies with reference to the manufacturing department. A company manufacturing coal gas sells not only the gas but the

by-product—coke. Gas coal of certain grades is supposed to produce fairly even quantities of gas measured in cubic feet and stored in gas tanks. The auditor should test both the quantities of gas produced according to these standards as well as the supply of coke, and by means of such verification of production he should be able, after applying beginning-and-end inventories, to come fairly close to quantities which should be accounted for through the sales. The gas once accounted for as having been produced and delivered to the gas tanks can from there, after making a percentage allowance for normal leakage, be quite accurately traced to the consumer or the consumption records. Any great variation between production and sales should be carefully investigated. Tapping of gas mains is by no means an unusual crime. The offense can generally be traced through the subsidiary local distribution meters.

WATER COMPANIES

Water Rates. Water rates are usually fixed by the number of rooms of a dwelling or apartment, by meter measurement, or on the basis of facilities used by the consumer (i.e., for hose faucets, kitchen faucets, and bathroom faucets). Privately owned companies generally resort to the meter rates, and municipally owned plants are rapidly adopting the same basis. The charges to consumers on a meter basis are treated in the accounts in the same way as in electric light, power, and gas companies, so that the auditor is confronted with the same records for recording income. Where flat rates are charged, the auditor must see that the company carries a liability on its books for the income not earned, flat rates as a rule being paid in advance during different periods of the year.

Water rates take on the status of tax claims in the case of municipally owned plants, so that the loss from bad debts is very small. In many states a claim of this kind, if unpaid, becomes a lien on the property.

Test Yourself on Essential Points

1. Name four general classes of income for a telephone company.
2. Outline the large items of expense in a telephone business and state how you would proceed to verify their correctness.
3. Explain the difficulties in securing a complete reconciliation between production and consumption in an electric light and power company.
4. How would you account for gas production and consumption?
5. What are some of the special points to be considered in the audit of a water company?

Chapter XXVIII

AUDIT OF SPECIAL BUSINESS TYPES (Cont'd)

Financial Institutions

National and Federal reserve banks—Audit of cash and securities—Audit of state banks.

The audit of financial institutions, though in many respects quite simple as compared to other audits, is probably of far greater importance because of the relation of financial institutions to the public. It is, of course, true that all industry must appeal to the public for support. The manufacturer looks to the public to buy his wares, and so does the wholesaler and the retailer, but financial institutions ask for actual cash or the equivalent of cash. They wish either to conserve or to deal with the finances of the nation. Their manipulations and functions are so important that if improperly conducted, they may plunge a nation into a panic. This condition necessitates close governmental supervision in many cases and requires a high degree of ability and care on the part of the public accountant who may be called in to audit the accounts of such institutions.

It will be quite impossible to cover more than the most important types of financial institutions in this discussion, and even within these limits we must confine ourselves to generalities and essentials. The financial institutions to be discussed have, therefore, been limited to the following:

1. Banks:
   - National and Federal reserve.
   - State.
   - Savings banks.
   - Trust companies.
2. Bond and stock brokers.
3. Building and loan associations.
4. Miscellaneous financial institutions.

NATIONAL AND FEDERAL RESERVE BANKS

In making an examination of a national bank an auditor should not, except in the case of a special investigation, regard himself as engaged by the officers or interpret his efforts as being directed by them. He should represent the board of directors, the stockholders, and the depositors. Incidentally, since national banks are under government supervision, he should view his work as supplemental to that of the national bank examiner's and in this way not only serve the government but arouse it to some of the important defects in governmental examinations.

Audit of Cash and Securities. In auditing a bank of any kind the balance-sheet accounts must first be considered. These accounts reflect the bank's stock in trade and fluctuate widely from day to day. The audit of the cash and securities comes first, and the following procedure is recommended:

1. Very few of the bank's officers and none of the employes should know of the audit.
2. A sufficient number of assistants should be employed by the auditor so that every clerk in the bank handling cash or securities can be checked up simultaneously, as a safeguard, and in order to dispose rapidly of this portion of the work. (In order that the bank's activities may not be disturbed, the audit should be started preferably on a Saturday noon at closing, thereby permitting the auditors to work Saturday afternoon and night and all day Sunday, if necessary, to verify the cash and securities before Monday morning.)
3. The first act should be the sealing of all the vaults wherein the securities are kept.
4. The cash and securities in the hands of all the tellers and others must next be counted, and in such a way that they are counted simultaneously. This means a sufficient staff so that all the cages can be handled at once. They must not be taken up in rotation. When handled in rotation it is possible to transfer funds from tellers whose cash has already been counted and verified, to other tellers who may be short. Either the cash count must be begun

simultaneously in all cages, or all cash must be brought to one central point and treated as a unit. No access to the vaults should be permitted during the cash count.

5. After all cash has been counted and the tellers' books verified, the cash should be placed in properly labeled receptacles and removed to the vaults. Checks which are to go to the clearing house must be inspected as to their genuineness and a certificate for confirmation inclosed in each clearing-house envelope, which the clearing house should be requested to mail directly to the auditor in a stamped envelope addressed to himself. The certificate should confirm the checks sent to the clearing house and give detailed information as to any checks returned unpaid.

6. The securities and other papers in the vaults must next be counted and properly segregated. A distinction should at once be observed between securities held as collateral for loans and the bank's own securities. The latter should agree with the general ledger account unless some of the securities are in the hands of correspondents. In the latter event the correspondents should be requested to confirm direct to the auditor the amounts held by them. A certificate should also be requested of the United States Treasurer for bonds in his custody to secure circulation or local Federal deposits.

7. In a federal reserve bank all rediscounted paper must be carefully examined and the local reserve members requested to verify the amounts of such rediscounts. In general this whole feature must be carefully examined so that a strict compliance with the Federal Reserve Act may be observed. The collateral securities deposited must be clearly admissible, as provided by the Act; and they must be very carefuly inspected. The Federal Reserve Act and the rulings in connection therewith should be carefully studied by the auditor before he begins this work.

8. Depositors' accounts form the basis of a bank's existence, and some very thorough tests should be made of the balances in these accounts. Most banks now render monthly statements to customers, the customers being requested to confirm the balances on a confirmation slip inclosed with the statement. The auditor should take this matter into his own hands and should call for all customers' statements. These should first be compared with the ledger balances and then mailed by the auditor himself, who should inclose his own confirmation certificate to be mailed direct to his office. Tampering with customers' accounts has been largely eliminated by the proper distribution of functions among bank employes. One who handles cash or securities is not given access to the customers' ledgers and, moreover, the ledger clerks are switched about frequently, thus preventing at least any extended manipulation of the accounts. The new ledger clerk, as a matter of self-protection, will make a very through inspection of the accounts before accepting responsibility for his predecessor's entries. A further internal check may be provided by employing a statement clerk who compares the balances in the ledgers with the statement balances and who further receives the customers' confirmations.

The deposits and withdrawals for some time prior to the end of the audit period should be compared by checking the customers' confirmed statements with the ledgers. Any entries in a depositor's account other than for deposits and withdrawals should never be passed by the auditor without thorough investigation, and the proper authorizations for such entries must be produced. The entries for deposits and withdrawals must, moreover, be compared with the receiving and paying tellers' records, respectively. Such comparisons, although they must be confined to tests, are very productive in exposing any irregularities. Checking the depositors' accounts in totals against the tellers' total records of deposits and withdrawals and the totals of clearing house, draft, and certified-check records often reveals differences which may thereupon be localized.

9. The Capital Stock Account per general ledger should be proved by reference to the stock certificate books and the stock ledger. All capital stock indicated as issued should be accounted for through values or cash received.

10. Loans to officers should be carefully examined and the collateral therefor subjected to the same scrutiny as other collateral. All overdue paper for loans to officers or others should be listed and its collectibility ascertained. The signatures of all note makers should be carefully examined and compared with any other signatures available. The financial statements of borrowers should also be inspected and a memorandum made of the extent of loans

to companies in which bank officers and directors are interested as well as of the discount or interest rates extended to such companies. Collateral notes should indicate specifically the security pledged, and the assignment of these securities must be beyond question. The makers of unsecured paper or of demand notes should be requested to confirm the amounts of their loans to the auditor direct; any payments on account but not recorded would thereby be discovered. Confirmations as to amounts and as to collateral security should also be requested from all other borrowers.

11. The income from discounts and interest should be tested both as to amounts and as to rates. The income of a bank is not confined to the interest and discount charged its customers, since there is considerable income derived from its own securities. Unearned discounts must be verified. A recent order from the Comptroller of the Currency now requires National banks to report discounts as income when earned, and not at the time the notes are discounted as was the prior custom.

12. A bank's expenses do not differ much in nature from the expenses of other business institutions. Salaries form the largest item, and these should be verified in the usual way from the pay rolls. Thorough tests should be made of interest paid on depositors' accounts, and proper receipts should be demanded for postage purchased. The expense accounts of bank officers should be carefully scrutinized and any unusual items reported.

STATE BANKS

Quite a number of states have provided effective control over banks incorporated under state banking laws. Wisconsin is probably the leader in this form of control, and is securing satisfactory results. In that state the control begins with the regulations as to incorporation and continues while the bank remains in business by means of frequent examinations and by control of the bank's investments and loaning privileges.

The audit of state bank accounts does not differ from the audit of national banks except that the state laws and the state banking regulations must be studied by the auditor before he begins his work. The activities

of the management with reference to the connection of their banks with their other interests must be carefully investigated. State banks have in some instances been incorporated as means for financing the incorporators' other business interests. A thorough examination must be made with reference to the adequacy of the bank's reserves.

Test Yourself on Essential Points

1. In making an audit of a national bank, what class of persons does the auditor represent?

2. Outline in detail the procedure for auditing the cash and securities of a national bank.

3. Explain any differences that exist in the audit of a state bank as contrasted to a national bank.

Chapter XXIX

AUDIT OF SPECIAL BUSINESS TYPES (Cont'd)

Financial Institutions (Cont'd)

Depositors' accounts in a savings bank—Verification of securities—Nature of audit of trust companies—Bond and stock brokers—Securities on margin—Collateral loans—Customers' accounts, long and short—Verification of cash and securities—Margin accounts.

SAVINGS BANKS

Depositors' Accounts. There are so many inactive depositors' accounts in savings banks that the most important task in an audit is the verification of depositors' balances. Many of these remain unaltered for months or years, and the opportunity to conceal defalcations, through the manipulation of such inactive accounts, is extensive. For the auditor there is here an imperative duty. He must secure confirmations from the depositors and must request that they be mailed to him direct or he must check the pass books as they are presented.

Verification of Securities. Savings banks are subject to more or less restrictive legislation in the various states. Their investments are limited to certain forms of securities. In many states they do not discount paper or make unsecured loans. They are in this respect quite similar to trust companies. In fact, they are the conservators of the people's savings. Their assets must therefore consist of non-speculative investments, such as bonds and mortgages. The auditor must examine these securities very carefully and verify the income from them. He should, in the case of bonds, determine their market values and their admissibility as investments under the law. Any mortgages on real estate must be recorded and sufficient insurance carried on the property. The insurance policies must, of course, be assigned to the savings bank.

TRUST COMPANIES

Trust companies act not only in a fiduciary capacity, but operate safety deposit vaults, deal in real estate, make real estate loans, and buy and sell bonds. As trustees for bond issues their functions are limited to the collection and disbursement of interest on the bonds and to the enforcement of the stipulations contained in the trust indentures. As trustees for estates, it is their duty to submit to the beneficiaries proper statements of income collected and the expenses of administration, and to pay over to the beneficiaries the net income or to invest it, as the case may be, according to the provisions of the trust agreement.

Nature of Audit. The auditor must satisfy himself that the trust company is fully complying with the terms of all their fiduciary contracts and that accounts to the beneficiaries and principals are regularly and properly rendered. All trust funds must be verified by actual count and inspection of the securities thus held, and from these the income payable to the beneficiaries must be verified. A trust company's income consists of commissions or fees from the trust department, commissions from the real estate department, rents from safe-deposit vaults, and profits from the sale of bonds. The income from all of these sources must be carefully tested. The operations of the bond department should receive rather detailed examination, especially in cases where entire bond issues are purchased to be offered for sale to the public. Such purchases must be in safe investments and the auditor should examine generally all engineer's surveys, legal opinions, and public accountant's certificates and reports submitted in connection with the bond issue.

It is practically impossible to verify the entire income and expenses of a large trust company in detail. The system of internal check and control over the accounts must, however, be satisfactory before an auditor may conclude that only tests will be necessary. The mere

presence of volume is no excuse for making only tests of accounts. Tests are justifiable only where volume is accompanied by unquestionably effective internal audit.

The investments of trust companies must be actually counted and inspected by the auditor and all the income therefrom fully accounted for. It is advisable to count the securities at the very beginning of the audit and at such a time when the client will be least inconvenienced thereby. The importance of proper general ledger controlling accounts for the various departmental activities cannot be overemphasized by the auditor. Each department ought to show a profit and should therefore, if conditions permit, keep its accounts on a proper basis.

BOND AND STOCK BROKERS

Bond and stock brokers, as the name indicates, are primarily middlemen, although in order to have working capital they themselves are as a rule heavy investors in securities which they buy and sell, or use as collateral for bank loans. They buy for customers outright, in which event the securities purchased are delivered, or they carry securities for customers on margin. The proceeds from sales of customers' securities are either remitted to the customers or retained by the broker as deposit accounts if the customers so desire. Interest is allowed the customers on these deposit accounts and they are carried in practically the same way as regular bank deposits.

Securities on Margin. Securities carried for customers on margin are not delivered, but are retained until the customer orders a partial or total sale thereof. The profit on the sale is then credited to the customer's account and the commission earned by the broker is charged. Whenever the customer's marginal security falls below the number of points required, the broker requests additional margin. If the latter is not forthcoming, the customer will be "sold out" and the margin or a part

thereof will be forfeited. The securities carried for customers on margin are used by the broker as collateral for loans or are carried "in the box" until they are sold.

Collateral Loans. As a result, the collateral on loans is constantly changing; therefore it is very important that a statement from the banks be secured immediately when an audit is started. All loans (which are generally demand loans) are recorded separately in a loan register and the list of bonds and stocks used as collateral for each loan is clearly indicated. This list should be copied at once by the auditor and mailed to the bank for confirmation. The confirmation request should cover both the loan and the collateral.

Customers' Accounts. Statements of customers' accounts (generally press copies) are mailed at the end of each month. They show the transactions for the month, the balances and securities long and short at the beginning and the end of the month, and the securities received and delivered. An audit of stock broker's accounts should always start at the close of a month's business, so that the auditor may himself mail to the customer the press copies of their ledger accounts and inclose his requests for confirmation. Before these are mailed an assistant must record from each customer's account the securities long and short under the captions of the various securities as follows:

CUSTOMERS' BALANCES

MISSOURI PACIFIC 5's

Long		Short	
John Smith	20 M	Tom Brown	15 M
Fred Jones	40 M		

etc., etc.

U. S. STEEL, COMMON

Long		Short	
John Smith	10 shares	Tom Brown	60 shares
Fred Jones	100 shares		

etc., etc.

Verification of Cash and Securities. Simultaneously with the preparation of the long and short schedule from the customers' statements and the preparation of confirmation requests for bank loans and their collateral, the auditor and his staff must at once count all the cash and revenue stamps and check these against the general ledger accounts. He must also, before the next day's transactions occur, examine and list all the securities on hand or borrowed and compare his lists with the general ledger controlling accounts.

The lists of securities on hand (of stocks loaned and borrowed and in transit and of stocks long and short in customers' accounts) should be compared with the stock ledger, and the broker's own long and short securities with the general ledger. All of these comparisons must be made, lists prepared, and confirmation requests mailed before the next day's transactions begin, because the many changes occurring daily make it extremely difficult to iron out any differences occasioned by subsequent transactions. Securities in transit may be readily verified by requesting confirmations from branches at the close of the same day on which the audit of the main office accounts are begun, and by having the audit of the branch accounts started at exactly the same time.

Confirmation Requests. Confirmation requests should be mailed to all customers and to other brokers. Customers' accounts for which no statements are mailed, must be carefully investigated and brought to the attention of the management. The omission of such statements may be perfectly regular, as in case customers have requested the broker not to send statements because of personal reasons, or it may indicate the use of such accounts for illegitimate objects. Unless letters are on file from customers specially requesting that no statements be sent them, it is the auditor's duty either to mail out all statements, irrespective of any excuses on the part of the broker's office force, or to send an assistant to the customer with a copy of the statement and a personal request for the verification thereof.

Margin Accounts. The Margin Accounts must be very carefully investigated. If the margins are insufficient, the matter should be brought to the client's attention. The same care must be exercised in verifying interest and commission charges and the interest paid to banks and other brokers. The income from the client's own securities must be fully accounted for, the bank accounts reconciled, the trial balances of all subsidiary ledgers verified, and all accounts in the general ledger thoroughly inspected.

Necessity for Study of Records and Systems. The books of bond and stock brokers are very different from the books of other business concerns; therefore an auditor should be cautioned to put some study on the subject before beginning an audit of this kind. Often cash journals are used to record cash receipts and disbursements, and securities delivered and received. The cash receipts and securities delivered are on one side (generally the left) and the cash disbursements and securities received on the other. In most other respects the accounts are similar to those of other businesses. The most important thing to do in an audit of stock brokers' accounts is to secure at the earliest possible moment a balance between the lists of stocks and bonds short or long, as per customer's ledgers, and the lists of stocks and bonds deposited with bank, on hand "in the box," and securities in transit. If the auditor has made no error in preparing his schedules and if the accounts are in order, the lists will balance exactly. In order to make an audit of stock brokers' accounts of any value, it must not only be thorough but detailed to a fine degree. The dangers from fraud and error are so great that anything short of a detailed audit is practically worthless.

Test Yourself on Essential Points

1. State how you would proceed to audit the accounts of a bank. (From American Institute Examination.)

2. What limitations are placed upon the kind of investments made by savings banks?

3. What are the sources of a trust company's income and what procedure should be followed to audit such income?

4. In auditing a trust company's accounts, you find that the company is co-trustee for a number of estates. The securities are locked in a safe-deposit box that cannot be opened without the assistance of the absent trustee, who will be away for several months. What precautions should be taken to safeguard the integrity of your audit? (From C.P.A. Examination.)

5. State in detail the work it is necessary to do the first night on the accounts of a firm of stockbrokers, in order to make an audit satisfactory to yourself and allow the routine work of the office to go on the next morning. (From C.P.A. Examination.)

Chapter XXX

AUDIT OF SPECIAL BUSINESS TYPES (Cont'd)

Financial Institutions (Cont'd)

Sources of income of a building and loan association—Procedure for verification—Segregation of profits by securities—Form of cash accounting—Other financial institutions—Investment companies—Investments at cost—Valuation of investments on balance sheet—Business brokers

BUILDING AND LOAN ASSOCIATIONS

There have probably been more defalcations in connection with building and loan associations than in any other form of business activity. This condition has been due to "one-man" control over the funds and accounts of these associations. The auditing committees elected by the association members or appointed by the board of directors are, as a rule, amateurs in accounting, and their inspection of the records is therefore quite valueless. The accounts should be periodically audited by reputable public accountants. The audits should be made in detail and at very frequent intervals.

The income of building and loan associations is derived from the following sources:

1. Interest on loans.
2. Premiums on loans.
3. Income from investments.
4. Fines for delinquency in payment of dues and interest.
5. Initiation fees (sometimes credited to a reserve account and returned to the shareholders when their contributions have been all paid in).

Interest on Loans. Interest on loans must be verified from the Cash Account, the notes themselves, and the loan registers. In the larger associations, where the notes are all numbered, each number must be accounted for. The balances due on notes should be verified by correspondence with the borrowers. As the rate of interest

on all loans is the same, the verification of this income is quite simple.

Premium on Loans. Premiums on loans are obtained by a process of bidding by the stockholders, or a premium is charged outright. The minute book of the association should be inspected in this connection, since the making of all loans should be recorded therein. If the auditor has any suspicions with reference to premiums paid for loans, he should not hesitate to take the matter up directly with the borrower.

Income from Investments. In scheduling and examining the investments, which consist chiefly of real estate mortgages, the auditor should at the same time prepare a statement of the income therefrom. The mortgages should be supplemented by the insurance policies assigned to the association and by such documents as are necessary to establish the mortgagor's title. The auditor must also make sure that all mortgages have been properly recorded. All collateral on loans made to stockholders or others must be on hand and should be carefully inspected by the auditor.

Fines. The income from fines must be verified in its relation to the dues and the interest payments. Each member's record of payments must be investigated and each delinquency recorded. To do this effectively the auditor should call in all members' pass books or should inspect these as they are presented at a regular meeting of the association. This method will also afford the best proof of the outstanding capital stock. All the pass books for each series of capital contributions should be consecutively numbered, so as to make it possible to account for all books issued. Whenever delinquencies have been passed without the imposition of a fine, one of two things has occurred. Either the secretary has neglected to impose a fine, which is contrary to the by-laws, or else he has pocketed the amount. It may, of course, be possible

that fines have been remitted in special cases, but the board of directors would have to approve such action and the matter would in that event be covered in the minutes.

Initiation Fees. Initiation or admission fees in the case of building and loan associations are rather uncommon. Where such fees are charged, they are generally credited to a reserve account which becomes available when final distributions are made, or they are used for various specific purposes. In some few instances it may be found that they are distributed with the profits on some pro rata basis.

Segregation of Profits by Series. The profits of building and loan associations should be segregated according to the different series of capital contributions. It is not correct procedure to calculate the profits on a basis of the dues paid in during the year under audit. The accrued profits at the beginning of the year for each series must be taken into consideration as well as the accrued profits from the prior year withdrawn during the year. To put the matter on a formula basis, we would have:

Accumulated dues + accrued profits at the beginning of the year + an equivalent annual amount of dues paid in during the year — entire dues paid in during the year and accrued profits (of the beginning of the year) withdrawn during the year = average working capital.

(To be worked out for each series on which the profits are to be apportioned.)

Cash Accounting. A very convenient and serviceable form of cash accounting is coming into common use. The form is arranged as follows:

The numbers of the pass books are arranged consecutively in a vertical column. The columns spread across the page provide for the entry of dues, fines, or interest paid at each regular meeting. The totals of these col-

SERIES I

Number of Books	Week ending			Week ending			Week ending		
	Dues	Fines	Interest	Dues	Fines	Interest	Dues	Fines	Interest
1									
2									
3									
etc.									

umns will be posted once each week in the general cash book. All other cash received at irregular intervals will be entered in the general cash book direct. The auditor should, of course, recommend that all cash received be deposited intact in the bank and that all expenses be paid by check. The total of dues received will be posted once monthly from the general cash book to the Capital Account. Fines and interest will be posted to the proper controlling accounts for income. In the entire accounting scheme, the various series and the income and expenses in connection therewith should be kept entirely distinct from one another.

MISCELLANEOUS FINANCIAL INSTITUTIONS

There are in the United States a host of miscellaneous institutions, corporations, and individuals dealing in securities, that finance enterprises and deal in so-called "business chances." Some of these firms do a legitimate business and others are primarily swindlers. The latter class, naturally, rarely call in public accountants and whenever

they do the accountant's report is not for the public eye. It is unfortunate that state and national legislation has not removed these leeches from our financial circles. None of them should be permitted to ply his trade without government license, regulation, and examination. The most flagrant offenders of this class of so-called "financiers" use as their prey companies that are practically insolvent. The latter are induced to issue bonds, which from the nature of things can never be sold (unless by misrepresentation) and the "financier" collects a handsome fee for preparing a prospectus, for traveling expenses, and for having the bonds lithographed. Moreover, he charges a fat commission for the few bonds sold or handed over to creditors in liquidation of their claims.

No respectable public accountant can sanction such practices. Should he, by chance, be asked to audit the accounts of such swindling institutions, he should either refuse to take the engagement offhand or inform the prospective client that he will not treat as confidential any practices clearly fraudulent or dishonest. Let him assert that he will report any such practices to the proper public authorities for investigation. No auditor of character can afford to prostitute his calling on the theory that his relations to a client are purely confidential when the client is a rank offender against law and, in essence and fact, a swindler and reprobate.

It is wrong, however, to conclude that all small investment brokers and other institutions not heretofore discussed fall into the class whose practices we have just condemned. In fact, we have found as much and in some cases more real sterling honesty in small financial institutions than in some of the very large ones. In dealing with these miscellaneous types of financial institutions we must confine ourselves to two, namely, investment companies and business brokers.

INVESTMENT COMPANIES

Investment companies do not deal in securities as

agents for others. They represent combinations of capital for investment purposes, the theory being that where many individuals can merge their capital and have it distributed over a large variety of investments, the chances for loss are much diminished and the opportunities for gain considerably increased. Companies of this kind, therefore, buy securities for the income they yield and not as objects of sale. In auditing the accounts of such companies, the most important tasks are the verification of income and the counting and inspection of the securities.

Income from Securities on Hand. The income from securities on hand should be verified and tabulated from the securities themselves, and thereupon related to the cash book entry for dates of purchase. The income from investments sold during the year must be very carefully investigated, and should represent the accrued income from last interest or dividend date (or from the close of prior period) to date of sale. The cash book should show clearly the amount received in full, the profit over cost (if any), and the accrued interest. In the case of purchases, the cost of the investments and the accrued interest should be shown.

Investment at Cost. Very often investment companies buy up an entire bond issue at a discount. In that event the investment should be carried at cost and the profit shown when the bonds are retired or sold. If the bonds are retired serially, the difference between cost and retirement price should be shown as a profit as the bonds are retired. The following illustration will indicate the procedure necessary.

The bonds of the A Company, amounting to $100,000.00, are purchased at 96, and are to be retired by the A Company at the rate of $10,000.00 each year. The entries would be:

Company A Bonds	$96,000.00	
Cash		$96,000.00

To record the purchase.

Cash	$10,000.00	
Company A Bonds		$ 9,600.00
Profit and Loss		400.00

To record retirement of $10,000.00 bonds of Company A and profit thereon due to discount at date of purchase.

In cases like the above, the auditor must make sure that the credit to the investment account for bonds retired is at cost. Otherwise the balance in the account would indicate that the remaining bonds were purchased at even less than the original price, and the profit on the bonds retired would not be evident.

Profits on the sale of investments are sometimes, and very wisely, put into a reserve account to provide against possible losses from other sales. However, it would probably be quite proper to transfer the balance in the Reserve Account at the end of each year to Profit and Loss, thus making each year stand on its own base. The income from the securities themselves, as adjusted by the Reserve Account, would without question be available for dividends. The income would reflect truly the net results from the year's activities.

Valuation of Investments on Balance Sheet. For published balance-sheet purposes the investments should be shown at cost or market, whichever is the lower, but it is not necessary to make any adjustments for differences on the books of the investment company. An investment company is not a dealer in securities, and market fluctuations do not regulate the sale of its securities. An investment company should, and as a rule does, sell only when the market is favorable (that is, above cost), or it may sell below cost if it is thereby offered an opportunity to buy at a discount other securities which will result in an appreciable eventual gain. In an audit of such accounts it will, therefore, suffice if the auditor in his own balance

sheet states the securities at cost or market, whichever is lower, or if he comments on these values in his report. The company's books need not be altered.

BUSINESS BROKERS

Business brokers' activities are many and varied. They buy and sell stores for others, they secure loans, sell bonds and stocks, arrange leases, promote industries, locate factories, and do almost any number of other things by which sellers and buyers are brought together. Their income is, therefore, as varied as their activities, and yet it is quite necessary that the income be accounted for in its various forms and that the expenses be distributed accordingly, as far as that may be possible, practicable, and feasible. The auditor may make his worth strongly felt by offering constructive criticisms with reference to the proper systems of accounting whereby the income and expenses may be properly segregated and the profits from each activity clearly demonstrated.

It is advisable for the auditor to propose that the accounts be kept on an accrual basis. There is here no regularity in the cash income. Consequently accounts prepared on a cash basis offer no basis of comparison between periods. Moreover, unless accounts are kept with all customers, there is great danger of overlooking some of them. The auditor should inspect all accounts receivable very carefully, as many of them may be uncollectible. The real danger in a business of this kind is that of omission. Many arrangements are verbally made. The customers as a rule are bargain hunters and speculators moving from place to place, frequently without leaving an address, and the transactions are, therefore, more or less unsatisfactory and intangible. There are real difficulties before the auditor, with reference to both the verification of income and the valuation of assets. If, therefore, he will confine himself to constructive advice, after satisfying himself as far as possible with regard to the items of income and expense and the balance sheet,

his work will be well performed. Business brokers need accounting systems before they need audits, and if they will live up to the few following rules their profits will be more certain and determinable:

1. All cash received should be deposited intact in bank.
2. All bills and expenses should be paid by check or from a petty-cash fund operated on the imprest system.
3. All agreements should be reduced to written contract form, specifically setting forth the work to be performed, the remuneration therefor, and the mode of payment.
4. All accounts should be kept on an accrual basis and so segregated that the profits on each kind of activity may be readily determined.
5. Statements should be mailed to customers the first of each month and the accounts promptly collected when due.

Test Yourself on Essential Points

1. Outline the sources of income and the methods of their verification for a building and loan association.
2. How would you audit the income from securities owned by an investment company?
3. What principle should govern you in the valuation of securities on the balance sheet of an investment company?
4. What are business brokers and what conditions are there for the auditor especially to consider?

Chapter XXXI

AUDIT OF SPECIAL BUSINESS TYPES (Cont'd)

Insurance Companies

State regulation of insurance companies—Accounting records of a life insurance company—Verification of premiums—Testing insurance reserve—Past-due accounts—Vouching payments—Verification of investments—Analysis of surplus—Fire insurance companies—Premiums—Reinsurance reserve.

State Regulation. Insurance companies are under strict surveillance in practically all states of the Union. Moreover, the different states are quite severe on foreign companies who wish to do business within their bounds, and the taxes imposed upon such companies are often quite excessive. The insurance commissioners have much power and have not hesitated to use it. Consequently before auditing any insurance company, the auditor should become familiar with the state laws. These are much the same throughout the country with reference to general principles, but vary greatly in the details affecting operations. In most of the states the capital stock must be fully paid in before a company may start business, and its assets must have been inspected by the insurance commissioner. In other states, a minimum capital stock is required. After a company has once been organized, the states regulate the investment of the capital paid in by limiting it to bonds and first mortgages on property (otherwise unencumbered), ground rents, United States bonds, bonds of other states or political subdivisions of a state, and approved railroad bonds. The investment of surplus funds is also under state regulation. Although the provisions are more liberal, no loans may be made on personal security, the amount of single loans is limited to certain percentages of the capital stock, and there are other provisions regarding the total amount which may be invested in real estate mortgages. The companies are

usually prohibited from holding real estate except as it is necessary for the transaction of their business, or in case the property was obtained in satisfaction of debts, in which case it is to be sold at the first opportunity. The laws regulate the payment of dividends. Dividends may not be paid except out of net profits actually earned and must not be in excess of certain rates.

LIFE INSURANCE COMPANIES

It is very evident that an auditor must acquaint himself with the state laws regarding life insurance companies before beginning such an audit. The company must comply fully with these laws or its charter may be summarily revoked. The auditor must, therefore, know the laws fully in order that he may advise his client of any accounting procedure or acts contrary thereto.

Accounting Records. The books of a life insurance company are ordinarily kept on a cash basis. No entries are made to show unpaid past-due premiums. The policyholders' ledger merely indicates no payment, since there is no credit to such accounts. Death claims are settled in cash and no entry of the claim appears on the books until settlement is made. The principal books of an insurance company consist, therefore, of a number of cash books and the necessary ledgers. There is a general cash journal for recording the totals of receipts, the details of which are found in subsidiary records wherein the sources of income are designated and properly classified. These subsidiary records tabulate the receipts from agents, from the home office, and from foreign agencies.

The general cash journal contains the necessary columns for the general ledger controlling accounts. On the receipt side provision is made for premiums, interest, loans, mortgages, and real estate, and on the disbursement side, for agents' commissions and salaries, notes receivable, general expenses, traveling expenses, death claims, surrender values, mortgages, postage and

exchange, medical examination, and dividends to policyholders. An extra debit and credit column is provided for miscellaneous entries to be posted direct to the general ledger.

Premiums. Premiums on policies form the bulk of income. One of the first duties of the auditor is to verify this income. Under ideal conditions the total premiums credited in the general ledger should equal exactly the credits to the individual accounts in the policyholders' ledgers, but because of the almost limitless number of policyholders it is practically impossible to verify the income through the credits in these ledgers unless the company wishes to expend a great deal of money. Verification of income for a given period can, however, be accurately approximated by total comparisons between years. To the premiums of the prior year should be added all premiums on new business written during the year under review, and from this there should be deducted the effects on premiums from cancellation of policies, from paid-up policies, from death claims, from abatements, and from lapses.

The premiums received on new business may be verified through the examination of the policies issued, by making sure that all the numbers for the different classes of policies have been fully accounted for in the various subsidiary cash books. A very thorough test of premiums for the current year can be made in this manner, and since those companies employing public accountants generally have their books audited at least once each year, a very satisfactory check on premium income may be obtained.

Since duplicate copies of policyholders' accounts are kept in the actuarial department, where they are arranged according to classes or types of policies, a test comparison between the actuarial and the accounting department files should be made. The past-due accounts should be tested in this way.

Testing Insurance Reserve. The actuarial policyholders' files are segregated according to types of policies, and thereunder according to ages of policyholders at the time the policies were issued. This arrangement is necessary so that the proper reserves may be created for each type of policy. The calculation of these reserves requires a high degree of mathematical knowledge and training, and the average auditor is scarcely competent to verify the mathematical calculations forming the basis of the reserve construction. To make sure that these calculations are correct, he should call upon an actuary to assist him.

Past-Due Accounts. In order to ascertain whether all past-due accounts in the policyholders' ledgers are genuine, it may in some instances be advisable for the auditor to circularize these accounts in part or in whole, requesting that the policyholders mail their replies direct to his office.

Vouching Payments. All the disbursements for death claims should be carefully inspected, and properly approved vouchers must accompany the charges. Dividends to policyholders must be thoroughly tested, cash surrender payments vouched, and the disbursements for all expenses, salaries, and commissions carefully investigated. In the larger companies, where the internal check is extensive and efficient, fairly exhaustive tests of these various items will suffice.

The reports to the insurance commissioner should be compared with the company's own books, and the two should agree. The legal reserve must be properly constructed and must meet the legal requirements fully.

Verification of Investments. Probably the biggest task and an immensely important one confronting the auditor, is the verification of the insurance company's investments. These consist generally of the following groups:

1. State, municipal, railroad, and other bonds.
2. Bank and other stocks.
3. Mortgages and ground rents (first liens).
4. Premium notes secured by policies.
5. Policy loans.
6. Loans secured by bonds, stocks, etc.

These securities are listed in registers wherein the various classes are segregated. The totals in these registers must agree with the general ledger accounts, and the income from these securities may be computed from the registers. The registers show the name of the security, the date of purchase, the par value, the purchase price, the rate of interest (in the case of bonds, mortgages, and loans), and the due dates. These registers should be used in determining the income which is accounted for in the general ledger, thus providing an independent check against the cash records.

The securities themselves must be counted and carefully inspected by the auditor and his staff, or if deposited with the state insurance commissioner, that fact must be verified by correspondence. The counting of the securities on hand is a time-consuming task. Anywhere from 75 to 95 per cent of life insurance company assets are in the form of securities. However, just because of this fact and the strict requirements of the law regarding investments, the auditor must inspect and count the securities in full and, at the same time, assure himself that they are proper and according to legal requirements.

Tests of Liabilities. Among the liabilities the auditor should verify the following accounts by means either of exhaustive tests or of complete examinations wherever conditions permit or where the internal checks are weak:

1. Reserve as required by law (by far the largest item).
2. Additional policy reserve in excess of legal requirements (basis of construction).
3. Premiums paid in advance.
4. Policy claims awaiting proof.

5. Accumulations upon deferred distribution policies.
6. Miscellaneous current liabilities.

Analysis of Surplus. A very detailed analysis should be made of the Surplus Account and the payment of dividends. The states regard the Surplus Account of an insurance company as a provision for all contingencies not specifically provided for, rather than as available for dividends, and they have therefore placed a limit on the rate that may be paid.

FIRE INSURANCE COMPANIES

Nature of Premium. The audit of fire insurance company accounts presents no problems very different from those encountered in a life insurance company. The income, however, is treated somewhat differently, because of long-time premiums and because every premium received may become, at least in part, a liability. Premiums are therefore credited to income as earned and not when received.

The agents' reports contain the original entries of premiums, and a thorough test of these should be made by tracing these reports into the general books. Balances due from agents must be carefully examined, and accounts that are past due should be taken up with the proper official of the company.

All payments for losses must be *bona fide*, that is, must be properly authorized and paid to policyholders as evidenced by the premium or policyholders' ledger. All other vouchers for expenses, refunds, and abatements must be properly authorized. As in the case of life insurance companies, all investments in securities must be verified by actual count and inspection and the income therefrom proved.

Reinsurance Reserve. The liabilities of fire insurance companies are very similar to those of life insurance companies. The largest is the reinsurance reserve, and the basis of its construction is ordinarily fixed by state

law. This account must be verified by the auditor and he must satisfy himself that the law has been fully complied with.

The auditor should insist that ample reserves or liabilities be included in the accounts for accrued taxes and expenses, for losses in dispute, and for losses adjusted but unpaid.

Test Yourself on Essential Points

1. How are insurance companies affected by state regulation with reference to investments?

2. Outline the verification of premiums of a life insurance company.

3. What groups of investments are found by the auditor in a life insurance company?

4. Why is it important to analyze the Surplus Account of a life insurance company?

5 What is the reinsurance reserve in a fire insurance company?

6. A fire insurance company has gross assets, $26,000,000.00; reinsurance reserve, $14,000,000.00; gross liabilities, except capital, $17,000,000.00; surplus over capital and all liabilities, $7,000,000.00; capital, $2,000,000.00. What is the loss-paying ability of above company, i.e., surplus to policyholders? (From C. P. A. Examination.)

Chapter XXXII

AUDIT OF SPECIAL BUSINESS TYPES (Cont'd)

Publishers of books—Publishers of periodicals—Publishers of newspapers—Timber companies—Stumpage—Nature of dividend return—Proof of quantities of timber cut and sold—Depreciation—Audit of camp pay rolls.

Publishers

Publishers may be roughly classified according to the nature of their product as follows:

1. Publishers of books.
2. Publishers of periodicals.
3. Publishers of newspapers.

Publishers of Books. Publishers of books may do their own printing, binding, and selling, in which event the publisher is a manufacturer and the accounts will resemble those of an ordinary manufacturing business. The plant will be divided into departments and costs will be indicated on a departmental basis. The cost of sales will include the materials used, the labor employed, and the various departmental overhead expenses. All of these costs will finally be expressed in the finished inventory of books, the object of sale.

The auditor in this case must verify the inventories of materials, goods in process, and finished stock. He must assure himself as to the pay rolls and their distribution to the manufacturing departments, and he must make sure that all overhead expenses have been properly apportioned and included.

Verification of Income. In verifying the income based entirely on the sale of books, the proper procedure consists of reconciling the sales with production, that is, the Finished Inventory Account. The sales records should clearly indicate the titles sold, in quantities and values, and so afford the basis for monthly credits to Finished

Inventory Account and for royalties or commissions payable to authors or agents respectively.

Royalties to authors are based either on quantities sold or are figured on a percentage to sales values. If the sales records clearly indicate the quantities sold, it will be an easy matter to verify the credits to the authors' accounts. The multiplication of the quantities by the rate per volume will at once furnish the amount to which an author is entitled during any given period. When royalties are based on values, it will be necessary for the auditor to inspect very carefully the costs of production in order to make sure that they have all been included. In any event the royalty accounts must be tied up with the royalty contracts, which the auditor should carefully inspect.

As every author knows only too well, books do not always sell. The publisher can generally protect himself partly on a first edition by securing a proper guarantee from the author. Subsequent editions, however, are generally published at the risk of the publisher. Copyrights are often purchased outright. At any rate, in many cases the publisher has found that some publications do not sell and that the books on hand are worthless. Such books are not worth their cost and should be written off, or at least reduced to scrap value. To guard against conditions of this kind the publisher should carry a stock of titles based upon past sales as related to quantities on hand.

Consignments. Consignments of books to agents should be valued at cost and considered as part of the Finished Inventory Account. The reports of agents must be carefully scrutinized, however, and the publisher should insist on prompt remittances for books sold. Certificates verifying the inventories in their hands at the end of the period under review should also be requested from the agents.

Verification of Stock and Book Plates. The verification of finished inventory and of book plates ought to be a

very simple task. The amounts on hand, having been determined through the production and the sales records, may be verified in many instances by actual count. Since editions are limited to certain numbers of volumes, such tests are easy. There may be some overrun or slight shortages, but even these can be readily proved by reference to the quantities of stock used in production. The values placed on book plates are somewhat more difficult to verify. The values should be based entirely upon the demand for the publication and the probabilities of subsequent editions.

Plates for novels written by authors of limited reputation should be written off as a cost of getting out the first edition. The plates used in connection with standard publications for which the demand has proved fairly constant, may properly be carried in the inventories for a considerable period or until they have deteriorated beyond effective use.

Copyrights should be valued not on the basis of their unexpired life but on the basis of the demand for the books. An inventory of plates and copyrights can never give a publisher working capital, and the sooner he can recover these investments through sales (that is, by charging them off into costs), the more sound will be his business. For purposes of balance-sheet construction, all inventories should, of course, be carried at cost and reduced to market if the latter is lower.

Publishers of Periodicals. Publishers of magazines and periodicals do not carry a finished inventory stock which possesses any value (except as waste paper) after the dates of issue. As a result, production must be based closely on circulation. The only plates having any value are those held for long-time advertisers. It is very important that the auditor permit no valuation on old issues of magazines. He may make his work effective by preparing proper reports on the relation of production to circulation and the quantities of "left-overs." There

must be some left-overs, but only in sufficient quantities to meet a normal demand for old numbers, which may be established by an investigation of the publisher's experience.

Advertising. The largest revenue of magazine as well as of newspaper publishers comes from advertising. Advertising is directly related to circulation. As the circulation grows, the advertising revenue should grow. A sort of proportion should exist between the two, so that comparison of advertising revenue with circulation affords an excellent test of this relation as well as of the efficiency of the advertising department. The income from advertisements should be verified by multiplying the advertising spaces by the rates for each space. A test covering a number of issues should suffice. Newspaper advertising revenue must be tested, as it would be quite impossible for an auditor to verify the income fully. In both magazine and newspaper advertising, the contracts with the advertisers should be carefully examined and the rates charged on the books verified therefrom.

Circulation Revenue. Circulation revenue should be tied up with quantities printed after making the proper adjustments for copies returned, unsold, or spoiled. In fact, there is no other check. Enormous detail makes any other test impossible. However, all circulation accounts must be thoroughly tested as to their accuracy as well as to the mode of their construction. Circulation revenue from mail subscribers to magazines can be quite accurately checked by means of the total weight indicated on the mailing records or post office receipts. The latter, when divided by the weight of each copy, should give accurately the number of copies mailed.

The collection of subscription accounts or the handling of cash should be absolutely divorced from the circulation departments. If this rule is religiously observed, the circulation records themselves, if properly kept, should afford an excellent index to the circulation revenue. Subscriptions paid for in advance should be kept entirely separate from cash circulation and should afford the basis for monthly entries against the prepaid subscription liability. Outstanding subscription or advertising accounts must be carefully examined and proper reserves constructed for any that appear doubtful. Journal credits to such accounts must bear the proper approval.

It is important in any publishing business that all costs of production and operation be fully included. An examination of the cost records is very essential. Many publishers and newspapers conduct regular job printing departments. The auditor must be careful to assure himself that the various departments are charged with their proper share of overhead expense and that all idle time of equipment be taken into consideration. The pay rolls and the inventory accounts deserve very special attention, and the stocks used should be reconciled as closely as possible with production and sales.

Timber Companies

Stumpage Account. The most important feature in the audit of timber-cutting companies is the so-called "Stumpage Account." This represents the capital of the organization. It is the purchase price of the standing timber, and since the income is derived from the sale of cut timber, the Stumpage Account is a deferred cost of sales. For purposes of properly costing the sales, the Stumpage Account must indicate the number of feet of standing timber acquired and the unit price of each kind of timber (the unit is one thousand feet). The quantity of timber included is an estimate based upon the cruise of the company's timber expert. As a rule the estimate is conservative. Consequently, the timber company generally finds considerable uncut timber left after the Stumpage Account has been entirely written off into cost of sales.

Elements of Sales. As the depletion of the timber rep-

resents the use of capital invested, the sales price of timber or logs represents in part the capital which must be returned to the stockholders. It is therefore advisable to split the sales into the following elements:

1. Capital returnable to investors.
2. Operating expenses.
3. Interest on borrowed money.
4. Net profit.

Nature of Dividend Return. When dividends are declared, the portion of capital returned thereby should be clearly indicated. In fact, each stockholder should be advised that his dividend consists of two parts, namely, a certain amount of capital and a certain amount of profit. The accounting procedure necessary to accomplish this is fairly simple.

Let us assume that timber licenses have been purchased which are valued at $700,000.00 and that $700,000.00 of capital stock has been issued. The original entries would be:

Cash	$700,000.00	
Capital Stock		$700,000.00
To record investment by shareholders.		
Stumpage Account	$700,000.00	
Cash		$700,000.00
To record purchase of timber licenses for 148,000,000 feet of timber at the following prices:		
128,000,000 ft. Pine ..... @ $5.00 per 1,000 ft., or		$640,000.00
20,000,000 ft. Hemlock . @ $3.00 per 1,000 ft., or		60,000.00
		$700,000.00

During the first year 16,000,000 feet of pine timber and 2,000,000 feet of hemlock were cut and sold. The entries would be:

Cost of Sales	$86,000.00	
To Stumpage Account		$86,000.00
To record cost of timber cut and sold during the year as follows:		

16,000,000 ft. Pine ..... @ $5.00 per M	$80,000.00
2,000,000 ft. Hemlock .... @ $3.00 per M	6,000.00
	$86,000.00

The expenses of operation amounted to $150,000.00, interest on borrowed money to $3,000.00, and the timber was sold for $350,000.00. A condensed profit and loss statement would show the following:

Sales		$350,000.00
Deduct:		
Cost of Sales	$ 86,000.00	
Operating Costs	150,000.00	236,000.00
Operating Profit		$114,000.00
Deduct—Interest on Loans		3,000.00
Surplus Net Profit		$111,000.00

It is clearly evident that sales have returned not only the capital depleted ($86,000.00), but all expenses and interest, and have yielded a net profit of $111,000.00. The sales, therefore, represent the following increments expressed in percentages:

Capital Depletion	25.57%
Operating Costs	42.86%
Interest on Loans	.86%
Net Profit	30.71%
Total	100.00%

The balance sheet at the end of the year, assuming that all expenses had been paid in cash and that the sales were on a cash basis, would be as follows:

ASSETS	
Cash on Hand	$197,000.00
Stumpage Account	614,000.00
	$811 000.00
LIABILITIES	
Capital Stock	$700,000.00
Surplus (Net Profit for Year)	111,000.00
	$811,000.00

From this balance sheet, we can readily see that the Stumpage Account (the basis of investment) has been reduced by $86,000.00; that it has been converted into cash; and, further, that the net profits are also represented by cash. The company may legitimately declare a dividend of $197,000.00, representing $86,000.00 capital returned and $111,000.00 net profits from operations. The entries would be:

Capital Investment Retired	$ 86,000.00	
Surplus	111,000.00	
Cash		$197,000.00

More conservative methods, of course, would be to return the capital depleted, charging the entire amount to surplus and retaining the remainder of the cash for working capital, or to declare a dividend out of the net profits only.

By analyzing the sales into the various increments of costs, profit, and depletion of capital, the company will constantly have before it the elements to be considered in price making and the ever-present element of actual capital exhaustion. The auditor must see that this depletion is fully covered in the cost of sales.

Proof of Quantities of Timber Cut and Sold. An excellent auxiliary proof of quantities of timber cut and sold is afforded by the official scaling of government officials in Canada. No timber lands are sold in Canada. All cutting privileges are in the form of licenses, and the government collects dues from a timber company on the basis of units of thousand feet cut. The reports of the government scalers should agree with the company's own records.

Cutting and Driving Expense. The largest expenses of timber cutting are for actual cutting and driving. Large camps are provided for the loggers, where they are housed and fed, so that the commissariat is an important factor. Proper inventories should be maintained for all food and

camp supplies, and no stores should be issued except against properly signed requisitions. The food costs should be very carefully investigated by the auditor and, if possible, reduced to a unit basis for each camp. A comparison between unit food costs at the different camps will readily reveal extravagance, mismanagement, or pilfering.

Depreciation of Equipment. Timber companies make heavy investments in road improvement, bunk houses, dams and river improvements, drives, and transportation equipment. The larger part of these will be worthless after all the timber has been cut. It is therefore necessary for a company to estimate in advance the number of years required to cut the timber and to depreciate its properties annually in the proper proportion. Or, better still, the depreciation may be figured on unit production, which will extinguish the property accounts as soon as the total original estimate of standing timber has been written off.

Audit of Camp Pay Rolls. As the loggers are all paid in cash, it is important that the pay rolls be inspected carefully. An independent check on pay rolls is afforded by the camp stewards' records of meals served. No audit of camp pay rolls is complete or adequate without comparing these records with the pay rolls.

Since a great deal of cash is handled by the logging superintendent and his assistants, the auditor should investigate whether these employes are sufficiently bonded. He must also insist on proper safeguards in the cash accounting, and should demand proper vouchers or receipts for all cash disbursements.

As the purchasing of supplies must, from the nature of things, be allocated to one individual or to a very few, the auditor must look carefully into the purchases and inventories. Any inventory shortages must be satisfactorily explained before being accepted as normal. They may represent the effect of short deliveries.

Test Yourself on Essential Points

1. How would you verify the income of a book publisher?
2. Is it advisable to capitalize the cost of plates and copyrights? If so, what method would you employ to amortize the cost?
3. State how you would verify the principal item of income of a publisher of magazines?
4. What is stumpage and how should it be valued on the balance sheet?
5. What are the parts that may make up a dividend return from a timber company?

Chapter XXXIII

AUDIT OF SPECIAL BUSINESS TYPES (Cont'd)

Important features to be considered in mine accounting—Royalties—Audit of branch accounts—Investigation of comparative costs of branch operations.

Mines

The audit of mining accounts is very similar to that of timber companies. In both instances the income is derived from the sale of the property forming the basis of the capital investment, and the material cost of sales represents the depleted capital increment of the selling price. The estimate of ore available is the entire Deferred Cost of Sales Account and it is therefore the practice to relate all costs to the mined ton basis.

Equipment, machinery, shafts, etc., should all be depreciated on a per ton mined basis, and will therefore be automatically written off (except the residual values) when the originally estimated quantities of ore have been produced and sold.

Wages are based on the per ton output of the miners, even though they may be paid according to per diem rates. The pay rolls must be carefully checked in order not only to verify their accuracy but to gain assurance that proper deductions have been made from the miners' pay checks for supplies sold them and for rents of houses furnished them by the company.

Royalties. Many coal mines are operated under leases, and royalties are based on tonnage or on the dimensions of the seams worked. The royalty agreements must be carefully examined by the auditor. He must satisfy himself that the royalties have been fully included in the costs and that proper liabilities have been set up therefor. The payment of royalties should also be investigated to see that payment is made in accordance with contract stipulations.

The sales of ore or coal should be carefully compared with the production records and inventories. The weights produced, less quantities used by the companies themselves, after the application of beginning-and-end inventories, should agree approximately with the sales as indicated by the shipping weights.

Some mining companies own and operate short railroad lines, stamping mills, and smelting plants. The auditor should examine all such auxiliary activities very carefully. He should generally make sure that all income is fully accounted for, that production is efficient, and that the proper distinction is observed between charges to capital and income accounts. He must also be sure that the total of dividends declared does not exceed the sum of net profits and capital depletion. In this latter connection he should ascertain the correctness of the original estimate of ore or coal available.

Branch Accounts

The audit of branch accounts is almost entirely dependent upon the systems in use and the relations existing between the branches and the parent office. It can readily be appreciated that where the branch carries stocks, makes its own sales and keeps the accounts receivable, finances itself out of its own collections, pays its salesmen and office help, nothing short of a complete audit of the branch, at the branch office, will be satisfactory. This is true even though the branch may send in monthly, or more frequently, detailed reports of inventories, sales, expenses, collections, deposits, and cash balances. The auditor must, under such circumstances, go to the branch office in order to verify the reports sent to the home office and the branch controlling account kept in the home office general ledger.

Wherever the branch keeps full accounts, as just indicated, the controlling account in the home office general ledger will represent the net investment in the branch office (namely, the branch cash, accounts receivable,

inventories, office furniture, and fixtures, etc., less the liabilities). In preparing the balance sheet of the home office the branch account must be analyzed so that the various kinds of assets and liabilities may be properly distributed among the balance sheet accounts. The branch balance should never be considered an account receivable.

In some instances, where branches collect no cash and carry no accounts, but serve merely as distributing and selling mediums, it may not be necessary for an auditor to visit the branch office. Such branches are generally allotted a fixed working or cash fund, and all payments therefrom must be accompanied by proper vouchers or receipts before the home office will replenish the fund. These branches, however, carry inventories, and if the auditor accepts the branch-managers' certificates therefor, he should so qualify his report. Branch inventories can, however, be checked quite accurately through the records of shipments from the factory or home warehouse and through the reports of branch sales. In fact, unless a reconciliation is obtainable on this basis, the auditor should refuse to accept the branch managers' certificates and should plainly report the discrepancies. Branch inventories should be valued at cost or market (whichever is lower) for balance-sheet purposes. Branch accounts receivable may very well be partly circularized. Many thefts of stock have been temporarily covered by fictitious accounts receivable.

In the audit of a large manufacturing concern, it was found that a certain branch manager opened up an account with himself under a fictitious name, billed much of the stock, and then reported that the account was uncollectible because the buyer had departed to "parts unknown." The culprit was exposed through the use of the city and telephone directories and by reference to the owner of the building whose address was given. These

sources clearly indicated that the account was fictitious and led to a full confession.

No audit of branch accounts is complete without an investigation of the comparative costs of branch operations with regard to branch sales. An auditor can clearly reveal thereby the relative efficiency of the various branch managers. In tabulating the costs and sales it would, of course, be unjust to compare the results obtained two thousand miles away with the operations of a branch located one hundred miles from the parent office. Comparison of this kind to be of any value must be made between branches operating under similar conditions. A branch in existence for ten years should be more successful than one just established. The following factors must be taken into consideration:

1. Distance from parent office and local conditions affecting sales (that is, the presence of other competition).
2. Years in the field.
3. Effect of freight rates.
4. Support given by the parent office through advertising, etc.
5. Kinds of product handled.
6. Extent of sales field and markets.
7. Populations served.
8. Effects of local conditions on expenses.
9. Experience of branch managers and their assistants.

Test Yourself on Essential Points

1. Outline your procedure in verifying the amount of depletion and the depreciation of machinery and equipment of a mine?

2. How would the auditor satisfy himself that the royalties of a mine have been fully included in the costs and that proper liabilities have been set up therefor?

3. Indicate what would guide you in examining and criticizing accounts receivable carried on the branch-office books of a business. What would you require before—

(a) Accepting the debts as good, or

(b) Writing off those you were told were bad?

(From American Institute Examination.)

4. Under what circumstances is it unnecessary for an auditor to visit the branch office, in the conduct of an audit at the home office?

Chapter XXXIV

AUDIT OF SPECIAL BUSINESS TYPES (Cont'd)

Internal audit and control of department stores—Summaries of sales—Verification of C.O.D. sales—Vouching expenses—Distribution of expense to departments—Cost accounts of contractors—Profit on uncompleted work—Verification of unfinished contracts—Sub-contractors—Auditing accounts of professional men.

Department Stores

The accounts of department stores are, as a rule, subjected to fairly efficient internal audit and control. The auditing department, however, primarily centers its activity on the sales, which are audited daily. The procedure for cash sales in the larger stores is as follows:

Summaries of Sales. The cash sales tickets, which have been assembled from the department cashiers, are first sorted according to the various cashiers' numbers. Thereupon each cashier's tickets are gone over and segregated according to the numbers of the sales clerks, and finally each sales clerk's tickets are arranged in numerical order. The sales are then summarized on cashier's sheets, each representing a department. On each of these sheets the sales clerks' numbers are spread across and each clerk's sales placed under his number. The sum of all the columns represent the total sales for the day for the particular department. The summary prepared from all the departmental sales sheets represents the total cash sales of the day and must agree with the cash turned over to the general cashier. In many stores, department cashiers have been eliminated and all cash goes through tubes direct to the general cashier's office. In this case, however, certain cashiers receive the money from certain departments and their receipts should agree with the summaries prepared from the records of the sales clerks.

The sales clerks' books form the basis of all sales auditing. Some stores use different books for each kind of

sale; that is, they employ one book for cash sales, one for charges sales, and another for C. O. D. sales. Summaries of the charge and C. O. D. sales are prepared in the same manner as heretofore described for cash sales, and must agree with the general book entries. Other stores use sales books wherein the sales slip itself indicates whether the goods were sold for cash, charged, or sent C. O. D. The C. O. D. sales must agree with the records in the C. O. D. department, where all C. O. D.'s are independently recorded as a check on the drivers.

Verification of C. O. D. Sales. A professional auditor cannot be expected to check the detail work done by the auditing department of a store, but he should compare the various summaries prepared by it with the entries in the general books. The C. O. D. Account should receive careful attention; very often drivers neglect to make collection or the package has been improperly labeled, with the result that open balances appear in the C. O. D. ledger. The auditor should advise immediate collection of these accounts, and if the items appear at all suspicious he should request a direct confirmation from the customer of the balance due. There is always a possibility that the driver may have pocketed the money.

Purchases. With regard to purchases, the auditor should examine closely the system of approving and verifying the bills, the plan used in the receiving department for guarding against shortages and defective goods, and the provisions made for freight deductions and discounts. The better-managed stores watch all these features very carefully and take discounts almost without exception. This is done so regularly that the purchase record in use is ordinarily provided with a discount column, sometimes called the "Anticipation Account."

Vouching Expenses. It is not practicable for an auditor to vouch the expenses of a department store in detail.

Certain accounts, however, should be examined with considerable care. Executive and clerical salaries, the wages of drivers and packing-department employes, insurance on stocks and fixtures, and depreciation accounts should be quite fully inspected. The pay rolls of the sales clerks should be compared with the store auditor's sales analysis, and any padding will at once be revealed by such a comparison. Drivers' pay rolls can be verified by comparing them with the delivery records. Any unusual variations in expenses between periods should be run down.

Distribution of General Expenses. No audit of department-store accounts is complete without an investigation of departmental profits and operations. All departmental accounts should be controlled through the general books, and each department must be burdened with its proportionate share of general expenses. The auditor should therefore verify the charges to the departments for delivery expense, building depreciation, insurance and taxes, and all other expenses which are prorated. The basis of apportionment should be proper. All building expenses should be prorated to the departments according to relative floor space occupied; advertising expense, according to proportionate spaces utilized in the advertising mediums; and delivery expenses, either on a basis of relative sales or according to the weights of articles delivered.

The accounts receivable should be aged, and proper reserves should exist for past-due accounts. Inventories must be examined as to quantities, prices, and values, and proper depreciation should be provided for apparently unsalable merchandise. Certificates as to quantities on hand should be requested from the department heads.

The various cash funds in the hands of the cashiers must be verified by actual count, and where redemption certificates or trading stamps are issued, the auditor must see that proper reserves are created to provide for the redemption thereof. This reserve need not be based on

the entire quantity of stamps outstanding for, as a rule, a great many stamps are never presented. The auditor should ascertain the percentage of redemption to issue, and he should recommend that the reserve be constructed in accordance therewith.

Contractors

The accounts of contractors are essentially cost accounts. Therefore, proper cost accounting is necessary not only for securing data of particular contracts but in order to make correct estimates. Whether a contractor is engaged in building, excavating, or engineering work, it is necessary to secure accurate costs of all operations. Lack of proper cost systems has put many contracting firms into bankruptcy. On the other hand, some contractors have worked out their costs to such a fine point that many of their operations have become standardized. It is the auditor's duty to analyze and inspect the costs with great care. They form the basis of the largest asset account on the contractor's balance sheet—namely, Work in Progress.

Contract Accounting. An effective accounting system for contractors provides for general ledger control over all contracts, the contracts themselves being specifically indicated in a contract ledger. A voucher register should be employed. This should provide columns for charges to General Stores and Supplies (for materials used generally and carried in stock), contract ledger, general expenses, and direct general ledger charges. The charges to General Stores and Supplies build up the inventories carried for general use, and include commodities like sand, gravel, cement, lime, lumber, etc. As these are needed for specific jobs or contracts, properly signed requisitions should be prepared for their withdrawal, the requisitions forming the basis for journal charges to the contracts.

Purchases for specific contracts and for all expenses

(pay rolls, etc.) chargeable direct to contracts, would be entered in the contract ledger column of the voucher register. The contract ledger itself should be an analysis ledger. Each contract shown therein will be charged with materials used (indicating quantities and values of each kind), labor employed (hours, nature of work, and cost), and expenses. The ledger should be confined to contracts in progress so that the general ledger controlling account for work in progress may readily be verified therefrom.

As soon as contracts have been completed, the following journal entry should be made:

Cost of Finished Contract	$.....	
Contract Ledger		$.....

It is conservative policy entirely to ignore profits on unfinished work. Therefore, the contracts receivable ledger may either be treated as a memorandum record or be carried on the general ledger as a controlling account with a contra credit for Reserve for Unfinished Contracts. If the contracts provide for partial payments as certain portions of the work are completed, those portions may then be billed as accounts receivable, the entry being:

Accounts Receivable	$.....	
Contracts Billed (Income)		$.....

A corresponding reduction must, however, be made to the contracts receivable ledger and Reserve for Unfinished Contracts Accounts as follows:

Reserve for Unfinished Contracts .	$.....	
Contracts Receivable Ledger		$.....

Profit on Uncompleted Contracts. It would, of course, be permissible at the end of a fiscal period to take some part of the profit on contracts partially billed. The entire profit may be taken on partial billing if the latter covers some definite part of construction work for which all costs have been fully included.

To assure himself that stores are properly accounted for, the auditor should inspect the system thoroughly.

He must likewise investigate the methods of wage payment and the pay rolls. The men should be paid by employes who have no connection with the preparation of the pay rolls. Where cost accounts of adequate form are used, the pay rolls may be readily proved through the daily time reports of the laborers, which are independent of the foremen's time books and relate to the distribution of employment on the various contracts. Where labor operations have been standardized, padding of pay rolls rarely occurs. Any padding would immediately be made evident through the increased labor cost.

Verification of Unfinished Contracts. Unfortunately, many contractors do not keep proper cost accounts. In such cases an auditor must verify the account for unfinished contracts from the certificates of engineers or architects; these indicate the quantity and value of the work completed from time to time, and form the basis for the partial payments on account. The auditor should secure such additional certificates as are necessary to prove the values of unfinished work not billed at the closing date of the period under review.

It is important that the auditor assure himself that all costs are included in the charges to the contract ledger, and especially that certain items often overlooked are fully considered. Such items are particularly the depreciation of machinery, equipment and tools, taxes and insurance on these, and general expenses growing directly out of the contractual relations.

Subcontractors. In large building contracts much of the work is performed by subcontractors engaged by the general contractor. The auditor must inspect the charges made by the subcontractors very carefully. In every instance the charges ought to bear the approval of the general contractor's superintendent and should indicate formally the acceptance of the work as satisfactory. It should be remembered that the general contractor bills

all the work completed by the subcontractor, and that this work must be as fully acceptable to the owner as the work completed by the general contractor himself. It is also important that the auditor investigate any liens or claims of the subcontractors against the general contractor, and that these be properly reserved for. The owner will demand that the completed structure be turned over to him free of all liens or claims from subcontractors or mechanics.

Professional Men

Professional men, with the exception of architects, rarely have their accounts audited. In fact, some of them keep no accounts at all or are content to limit themselves to duplicates of bills rendered for professional services. A public accountant may be of great service to these men by recommending simple and effective accounting systems.

Since the income of professional men is derived almost

ORIGINAL

Prescription No.....

Patient .....

Address .....

Night Call.....Day Call.....Office.....

Remarks:

Dr.....

entirely from fees, it is important for the auditor to recommend a proper system for recording fees collectible.

Doctors. In the case of a doctor, it might be recommended that his prescription pad be so arranged that a carbon copy of each prescription written may be retained. The original and duplicate should bear the same number, and the sets should be consecutively numbered. The form on page 311 (in duplicate for each prescription) is suggested.

This original prescription should be perforated at the top so that it may readily be removed from the pad. The carbon copy thereof will remain in the pad or book and is, therefore, not to be perforated. This form will serve for night and day calls as well as for office visits. It should also be used when no prescription is written so that the pad will afford a complete record of all calls and office visits. The pad should be used at the end of each month for making out the bills to patients or for entry of charges in the patients' ledger. If the physician desires to keep a general ledger in addition, he should make a monthly journal entry charging patients' ledger and crediting Income from Night Calls, Day Calls, and Office Consultation, respectively.

The auditor should carefully investigate all old accounts with patients and suggest proper reserves for those apparently uncollectible. The credits to patients' accounts should be examined, and where no cash book is used these should be reconciled, if possible, with the physician's bank deposits. The status of accounts turned over to collection agencies should also be determined. It is advisable, of course, for a physician to have a complete set of simple, effective bookkeeping records, to deposit all of his receipts, and to pay his bills for taxicab service, drugs, etc., by check. Some doctors supply their patients with drugs and medicines. The auditor should then examine the purchase invoices and at least approximate the balances of stock on hand in order to state correctly the

income for the period covered by the audit. Automobiles, buggies, and horses used in practice should be adequately depreciated.

Lawyers. Lawyers should keep close watch over the time given by them to clients. In fact, most fees, if cases are not taken on a contingency basis, are based on per diem rates. A lawyer may very well keep his accounts in the same manner as a public accountant. Cases not taken on a flat fee or contingency basis should be charged according to the number of hours devoted to them.

It is customary for lawyers to handle many funds for their clients. These should always be kept distinct from a lawyer's personal funds. The auditor should strongly recommend such separation because the practice of treating clients' funds as part of his own may seriously affect the reputation of an attorney even though no injury may have resulted. Whenever attorneys act as trustees for estates, the accounting for estate income and expenses must be carefully investigated.

Architects. The accounts of architects and architectural firms vary according to the size of their businesses. Comparatively few of the smaller firms ever have their accounts audited. The larger firms, however, frequently call in public accountants and have more or less efficient and extensive systems of accounting. The verification of income from fees and commissions is the most important feature in the audit of these accounts. As fees are generally based on certain percentages to contracts, architects must keep a record of contracts and the payments made to the contractors. Fees are payable to the architect as moneys are paid to the contractor. There is no difficulty in determining the amounts due, because usually the architect himself must pass on the work before the contractor is paid.

Expenditures must be carefully examined, as many of these may be chargeable to clients. The Accounts Receiv-

able should reflect such expenditures in addition to the regular fee and commission charges.

Test Yourself on Essential Points

1. Outline your procedure to test satisfactorily the departmental sales of a department store.

2. In the verification of purchases what phases of system routine should the auditor consider?

3. What expense accounts should be examined with considerable care? Is it essential to verify the methods of prorating general expenses to departments?

4. In the audit of a contracting business what features are different from those of any other business?

5. Is it ever permissible to take a profit on uncompleted work?

6. State the special features, if any, in the audit of the accounts of architects, lawyers and doctors.

Chapter XXXV

AUDIT OF SPECIAL BUSINESS TYPES (Cont'd)

Procedure for verifying accounts of oil mills—Verification of yield—Depreciation—Checking cost methods of textile mills—Special features in the audit of automobile manufacturers.

Oil Mills

One of the largest industrial activities in the South is the manufacture of cottonseed oil. Cotton seeds as picked are covered with a lint which is removed in the ginnery. The seed itself is composed of the hull and the kernel which contains the oil. The oil content represents about 20 per cent of the weight; that of the hull and kernel are about equal. Besides the crude oil, therefore, cottonseed mills produce a number of other products, namely, cottonseed meal, the linters, and the hulls.

From the latter are obtained various by-products, such as cottonseed bran, stearin, and soap stock. The lint is sold as short cotton. After all lint has been removed from the seeds, the hulls and kernels are separated by being put into a reel. The hulls are baled or sacked and sold as stock feed. The kernels, after being crushed and cooked, are deposited in cake form between press cloth and the oil extracted by presses. The cake remaining after the process of oil extraction has been completed, is cracked and ground into meal or is sold as meal cake, in which event it is merely broken into pieces. Relatively little cottonseed oil is refined in the South. Most of it is sold in the crude state to refining companies in the East.

Verification of Yield. In auditing the accounts of cottonseed oil mills, one of the most important tasks is the verification of the yield. The record of operations during previous years should be utilized in establishing some norm upon which to base proper judgment as to yield.

The weight of seeds purchased must be checked up against production. There is, of course, a normal loss in weight because of seeds that cannot be used, but this loss should run fairly uniform over long periods of time. Any unusual shrinkages should be fully ironed out, as they may be due to manipulation of the production or inventory records. The purchases of seeds should be carefully vouched and the invoices compared with the stock records. The stock records should further be tied up with the payment of freight bills and the weights of the latter compared with the weights entered in the inventory accounts.

The auditor should be able to prove the weights of production by using the following formula:

$$a + b - c = \text{production.}$$

a = the sales (by weight) of linters, hulls, meal, and oil.
b = the weight of linters, hulls, meal, and oil on hand at the end of the period.
c = the weight of linters, hulls, meal, and oil on hand at the beginning of the period.

Seeds which cannot be used for oil production should be accounted for through Miscellaneous Sales or by adjustments to Inventory Account. An auditor's report should clearly indicate the sales as well as the seeds used, by weight. It should show the material cost per ton of sale as well as the per ton cost of operating. From such statements the proportional yields of oil, meal, hulls, and lint out of a ton of seeds will be readily revealed. This should be of value for comparison with operating records of prior years and will afford a clue to other than normal differences between yields.

Depreciation. Cottonseed oil mills run double time or the full twenty-four hours for six months or less each year. Depreciation is, therefore, a very heavy expense and must be more than double the normal rates for an average ten-hour-day run. In six months, the mills run a greater number of hours than other manufacturing

concerns do in a year. Where the normal running time of the latter is 3,000 hours per year, the oil mill will operate 3,600 hours in six months. The annual depreciation charges should be even greater than the percentage of excess, because machines in continuous service for twenty-four hours a day during a period of six months depreciate more rapidly than the above relation indicates. There are no idle periods for effective repairs, and the chances for sudden and disastrous breakdowns are greatly increased. Depreciation charges must, therefore, be very adequate. Moreover all other costs for the entire year must be absorbed into the operating period, for unless they are fully included during the period, the stated profits from operations may vanish entirely.

The idle season for cottonseed oil mills is utilized for repairing the machinery and rehabilitating the plant. Rehabilitation expenditures should be charged against the depreciation reserve, and the repairs should be set up as a deferred charge to be written off during the operations of the following season. In this way each operating period will be burdened with the repairs which were made to put the plant in effective working condition. The auditor must exercise great care in analyzing these expenditures in order to assure himself that the proper principles of accounting with reference to repairs and replacements have been observed.

Textile Mills

In the same degree that cottonseed oil mills are localized in the South, the textile mills are largely confined to the New England States. These enterprises form the bulk of the industrial activity of that section. Much good work has already been done by public accountants in standardizing the cost and general accounting systems of the textile companies, so that the public accountant called in to audit their accounts will usually find well-developed and properly controlled accounts.

Checking Cost Methods. As in the case of oil mills the important feature of the accounting here is the cost system. The auditor must, therefore, emphasize the examination of raw-materials inventory accounts, the production as related to purchases and manufacturing costs, and the sales as based on production. The inventories of goods in process and of finished goods must be carefully inspected to ascertain whether the basis of valuation is correct. It is needless to say that the values must not exceed cost. But, on the contrary, they should incorporate fully all legitimate elements of production costs. The methods of applying factory overhead or burden should be examined thoroughly. As so much of the work in textile plants is performed by automatic machines with processes very clearly separated by departments, the proper proration of factory overhead is quite easily determinable.

Automobile Manufacturers

The automobile industry has come to be one of the greatest in the United States. Apparently because of the installation of effective cost systems and through scientific management, the failures in this industry are now very few.

Cash Deposits. The demand for the well-known types of cars is so strong that the sales of manufacturers are practically assured for almost a year ahead. Orders for cars from local agents specify a given quantity and must be accompanied by cash deposits representing a percentage of the entire order. These deposits must be considered as liabilities until the orders have been filled. As the cars are shipped and billed, the Deposit Account should be reduced proportionately and transferred to the Sales Account. Some agents make a flat deposit which must be carried permanently as a liability or until the deposit is returned at the expiration of the agents' contracts.

Insurance on Finished Cars. A large item of expense, which should be carefully investigated, is the insurance carried on finished cars on hand, in transit, or with selling branches. Cars are sold to agents at flat prices, the prices to different agents varying sometimes according to the quantities sold under each contract. In addition, bonuses are paid some agents who sell cars in excess of a certain quota. Not only must the auditor examine the agents' contracts very carefully in order to verify the sales at the contract prices, but he must with equal care assure himself that all bonus calculations are proper.

Royalties. Another large expense is for royalties. Many of the devices used on cars are patented, and royalties must be paid to the patent holders. As these devices are used on practically all cars and as the cars are numbered consecutively, it is a fairly simple task to verify the Royalty Accounts.

The inventories of accessories can be readily verified in the same way; the quantities on hand should be proved by ascertaining the quantities used on the cars manufactured. To the inventory of accessories on hand should be added the accessories purchased, and from the sum of these should be deducted the accessories used. The latter quantities may be determined by multiplying the accessories going with each car by the number of cars manufactured. If this procedure does not prove the quantities on hand, then some accessories have doubtless been sold independently. The Accessory Sales Account should explain any discrepancy.

A great many automobile manufacturers merely assemble cars. They buy all their parts and even their motors from other manufacturers. The purchase invoices for these parts must be examined quite thoroughly and must be properly included in the inventory accounts. The auditor should also ascertain whether or not the officers of the company are interested financially in any of the companies from whom parts are purchased.

Not many years ago, during the course of an audit of a large and well-known automobile company, it was discovered that the president of the company was heavily interested in a number of companies from whom many of the largest and most valuable parts were being purchased and at a price considerably above the market. The object here was, apparently, because of a profit-sharing arrangement with another company, to divert the profits of the automobile company to the other companies in which the president was a shareholder. It is the auditor's duty to expose practices of this kind for the benefit of the entire body of stockholders, even though the president and his followers may be in control.

Advertising. The Advertising Account is a large one and should be checked to a certain degree from the advertisements themselves or, if conducted through agencies, by means of the contracts. Extensive publicity campaigns are generally in progress among automobile manufacturers. These assume various forms, chief among which are transcontinental runs and the entry of stock cars in races or hill-climbing tests. The expenditures in connection with these exhibitions are heavy and deserve careful scrutiny.

Since new models are sold almost every year, the Deferred Advertising Expense Account should be very small. It should be limited largely to unexpired advertising contracts. There is nothing peculiar about the advertisements of automobile manufacturers and most of them are very similar. The future results of any specific insertion are therefore somewhat doubtful, and to defer the expense thereof is an act open to just criticism.

The Deposit Accounts to the credit of dealers, just referred to, should be verified by correspondence. It may be possible that interest is to be allowed on these accounts and, if so, the auditor must set up the accrued portions thereof. The Deposit Accounts should not be

included with the accounts payable because they are deferred income accounts. However, until they are transferred to Income, they should be considered as liabilities. Very often the dealers or agents will charge the company for allowances made to their customers. In securing the dealers' confirmations with reference to the Deposit Accounts the auditor will doubtless find that they have claims which the automobile manufacturers may or may not have allowed. The claims of agents not recognized in the manufacturer's books should be thoroughly investigated in connection with the contracts in force. The claims of agents for customers may in some instances have to be verified by corresponding directly with the customers. Otherwise an unscrupulous dealer may very easily ask for allowances which he never granted his customers or he may call for free repair parts which he never furnished them.

The inventoried value of repair parts must be investigated with great care. The manufacturer must, of course, keep certain quantities of repair parts on hand. Many of these will be for cars sold in past years, and it is a difficult task indeed to anticipate correctly the quantities that will be required. Some manufacturers base the manufacture of repair parts on past experiences with other models of cars, but never make more than a limited number at a time. They guard against complete exhaustion by carrying a low minimum and by making a reduction in each new production order. The reduction in the order is based upon the gradual decline in demand for the parts. In almost every factory, however, the auditor will find a considerable quantity of repair parts that will probably never be called for. These inventories should be reduced to scrap value.

TEST YOURSELF ON ESSENTIAL POINTS

1. In order to make a satisfactory test of the yield in an oil mill, what factor should the auditor consider so that he may arrive at the proper conclusion? Give a formula to prove the weights.

2. How would you attempt to verify the adequacy of the reserve for depreciation of oil mill plant property, taking into consideration the idle season?

3. What features of the operations of a textile mill should receive special attention by the auditor?

4. How would you verify the deposit accounts of an automobile manufacturer?

Chapter XXXVI

AUDIT OF MUNICIPAL ACCOUNTS

Inefficiency of municipal accounting systems—Proprietary and fund accounts—City budget—Basis for tax rate—Appropriation ledger account — Encumbrances — Fund ledger — Income from taxation — Special assessments — Sundry revenues — Depreciation — Need for accounting system.

Inefficiency of Municipal Accounting. It is a deplorable fact that the vast majority of municipal accounting systems are woefully inadequate. With few exceptions, the accounts of cities are kept on a cash basis with no attempt to relate the various departmental expenses to the services rendered the public. No standards of efficiency have been created, no unit costs have been formulated, and no definite harmony has been established between the anticipated revenues and the estimated expenses. In many instances the results have been little short of chaotic. The ordinary cash book of a municipality is a hodge-podge of columns subdivided according to departments and bureaus, with no attempt at a proper classification of the sources of revenue.

In a few localities the public has rebelled against the ridiculous inefficiency of municipal accounting and financing, with the result that bureaus of municipal research have been organized. These bureaus have done much good in cities where it has been possible to limit the control of unscrupulous politicians. In many places, however, their efforts have been practically nullified by political grafters, whose wrong-doings were being exposed thereby.

Proprietary and Fund Accounts. The accounts of cities fall into two general groups, namely, the proprietary accounts and the fund accounts. The proprietary accounts, as indicated by the name, deal with the properties owned and their operation. The fund accounts are con-

cerned with the legal limitations placed upon the city officials with reference to expenditures.

The expenses of a city are in reality predetermined. Each year the various department heads prepare estimates of the funds they will require for the next year. These estimates are passed upon by the finance committee of the city council. The finance committee then recommends to the city council that the various amounts required be allotted to the departments and bureaus. The sum of all the allotments, or appropriations, is the city budget, and no department may spend in excess of its appropriation unless an additional appropriation is obtained from the city council.

Revenues and Appropriations. After an estimate has been made of the revenues to be derived from the municipal enterprises and from franchises, fees, fines, rents, licenses, etc., the total is deducted from the sum of the appropriations to the departments. The difference will represent the amount which must be raised by general taxation. This latter amount, divided by the total assessed value of real and personal property furnishes the tax rate. The opening entries for a year must indicate the sources of the estimated revenue and the allotment thereof to the various departments. They would be expressed in somewhat the following manner:

1. Estimated Income:
   Municipal Enterprises . . . . $.....
   Taxation . . . .
   Franchise . . . .
   Licenses . . . .
   Miscellaneous Sources . . . .
   Income Available for Appropriations . . $.....
   To record estimated income for the year available for appropriations.
2. Income Available for Appropriations . $.....
   Appropriation Ledger . . . . . $.....
   To record appropriations made by the city council to the departments as follows:

Police Department . . $.....
Fire Department . . ..
Department of streets, etc., etc. . . . .
Total Appropriations . $.....

The credit to Appropriation Ledger Account is posted in total to a general ledger account bearing that name, which thereupon becomes the controlling account for the sum of the various departmental appropriations which are entered individually in a subsidiary appropriation ledger. The warrant register should contain a column headed "Appropriation Ledger," in which all disbursements chargeable to the appropriation accounts must be entered. The individual entries in this column will be charged to the proper appropriation account in the subsidiary ledger, and the total of the column will be debited at the end of each month to the appropriation ledger controlling account in the general ledger.

Encumbrances. There are, however, other charges against the appropriation accounts. These are the so-called "encumbrances" or unpaid liabilities. They take the form of contracts, or open, unfilled purchase orders. It is therefore necessary to have a contract ledger and a purchase ledger, in which will be entered all contracts made by the various departments and the orders placed by them respectively. The contract and the open purchase order ledgers may either be made an integral part of the accounting system or be treated as memorandum records. In either event, the encumbrances recorded therein must be deducted from the balances in the appropriation accounts to show the free balance available for use for each department or division.

Contracts are specific in their amounts, and the contract ledger should therefore be actually tied up with the general books. As the departments enter into contracts, their appropriation accounts should be charged and a Contract Reserve Account credited. The latter account

will be cleared from the books by the charges from vouchers issued in payment of contracts. When a purchase order is placed, it is not always possible to estimate the final cost thereof. It is then sometimes feasible to carry the purchase order ledger as a memorandum record. In the latter event, the appropriation accounts would be charged directly with vouchers in payment of purchase orders and at the end of each month the unfilled orders would be considered as additional encumbrances so that the free balance could be properly shown.

Contract Ledger. The contract ledger, arranged by departments, should indicate the name of the contractor, the number of the contract, the nature of the work performed or the materials furnished, the date, the payments made, and the voucher numbers for the payments. The vouchers are charges not to the departments, but to the Contract Reserve Account, the departments having already been charged with the full contract originally and the reserve credited.

The purchase order ledger, also arranged by departments, must indicate the order number, the date, the date promised, the date filled, the estimated amount (forming the basis of the encumbrance), the date paid, the voucher number, and the amount paid. The difference between the estimate and the amount-paid columns will at any day represent the current encumbrance against the departmental appropriations for unfilled orders.

Fund Ledger. The fund ledger is of equal importance with the appropriation ledger, and the two can be very conveniently tied up with each other. All receipts are chargeable to the treasurer and should be credited to the proper fund account. The disbursements for certain departments must come out of specified funds. In fact, some funds are limited very specifically for the use of certain departments. Since all funds are charged to the treasurer, the disbursements must be credited to him

under each fund account. It is therefore advisable that in each fund account the following information be afforded—date of payment, voucher number, appropriation account charged, and amount. In view of the fact that the appropriation ledger indicates the vouchers charged against the appropriation accounts, the inclusion of the appropriation account name in the fund ledger will afford an excellent means for cross checking between the two ledgers. To facilitate this even further, it is recommended that the appropriation ledger contain (besides the date, voucher number, name of payee, and amount of the voucher) a column wherein the name of the fund account may be entered. The cross reference would then be absolutely complete.

It is impossible to discuss fully, in a book of this kind, the detailed accounting procedure of municipalities. Stress must be laid here not on accounting but on auditing procedure.[1]

Income from Taxation. The methods of accounting for income from general taxation must receive very close scrutiny. The taxes collected should agree with the amounts assessed in the tax roll, and any alterations in the assessments must be substantiated by proper authorizations. The taxes uncollected must agree with the general ledger-controlling account for taxes receivable, this latter account originally representing the entire tax roll.[2] Taxes in arrears must be fully noted, as these are liens against the property. When paid, the proper amount of penalty or interest collected therewith must be fully accounted for in the books. In some cities, after a specified time the tax liens are sold or the property itself is impounded. All such income must be ascertained and

[1] The accounts of state universities are similar to municipal accounts. A fair knowledge of the accounting procedure of one of the largest state universities may be gained by reference to articles of the author in the February and March, 1916, numbers of the *Journal of Accountancy* on "Accounting Procedure for State Universities."

[2] The Taxes Receivable Account is placed on the books after the tax roll has been completed. At that time the estimated Tax Revenue Account is credited and the account for taxes receivable is charged. Assessments collected are, of course, credited to the Taxes Receivable Account.

proved, and the auditor must satisfy himself that proper settlement has been made with the property owner.

Special Assessments. Special assessments for local improvements are very often collected in installments. The installments include the payment of principal, interest, and sometimes of penalties. The auditor must see that the various increments included in the payments are properly accounted for. Here the entire procedure in connection with the local improvements should be investigated. The city generally issues bonds to defray the expenditures for the improvement, and retires the bonds as the assessments are paid by the public. The interest on these bonds should be fully recovered through the interest charged on the deferred installment payments. The provisions governing the retirement of the bonds should be complied with fully and the funds derived from the collection of assessments should be properly reserved to pay the bonds as they fall due.

Sundry Revenues. The income from franchises, rents, licenses, and other sources should be verified through an inspection of the franchises, the rental agreements, and the subsidiary records detailing the location of resorts, stores, and other license-paying units. Some franchises provide that the city receive a percentage of the net profits of the franchise holder, the city in that event being granted permission to audit the franchise holder's books. This audit may be conducted by the city officials themselves or by a professional accountant. In the latter event, the accounts of the franchise holder must be very closely analyzed, especially with reference to charges against income.

As the department heads are very careful that their appropriations fully meet their annual requirements, the approval of vouchers charged to the departments receives detailed attention. All vouchers must be approved by the department heads and must be accompanied by evi-

dences covering the receipt of goods or of services rendered. The auditor must, however, give special attention to any unusual expenditures. He must make sure that the disbursements have been made from the proper funds and that the right departments have been charged therewith. He must also analyze the vouchers from the standpoint of account classification, so as to be certain that the proper distinction has been observed between charges to capital and income accounts. This precaution is necessary in order to verify the additions that have been made during a fiscal period to the city's asset accounts. Tests should be made with reference to prices paid by the city for standard commodities, that there may be no abuses or graft in the buying. In the best-governed cities all purchasing is in the hands of a single purchasing department. The advantages of such an arrangement are obvious. Larger quantities can be bought at reduced prices, inventories may be properly controlled, and the dangers of graft are reduced to a minimum. It is much easier to inspect and to control a centralized activity.

Where cities own public-service facilities, such as water, gas, and electric-lighting plants, and street railways, it is important that the proper accounting principles be applied in connection with their operation. Unfortunately this is not always done and one element of cost is generally omitted—namely, depreciation. Though it would be improper to set up a reserve for depreciation as in the case of private corporations, provision therefor should be made by annual appropriations for the estimated cost of replacement. The funds thus obtained could be invested in such a way that the combined principal and interest accumulations would suffice for the eventual restoration of the property. In this way each year would be burdened with its just share of depreciation, the bonds originally issued for the properties would be perpetually secured, and no single generation would be excessively burdened with an expense which prior

generations had refused to consider. The bonds issued when the properties were originally acquired would not have to be retired, but could easily be refunded because of the unchanged character of the security. The interest on the bonds should, of course, be defrayed from the net income of the various municipal enterprises and not from taxation.

Auditors will doubtless be called upon shortly to direct some of their energies to forming adequate accounting systems for municipalities. Sporadic efforts have already been made in this direction, some resulting in great good, others, not being properly guided, producing only mediocre results. The following suggestions are hazarded by us:

1. In order to gain the proper cohesion and co-operation between departments and the controlling elements in city organization, there must be a thorough study of functional relations. From such study, organization charts should be prepared. These would readily indicate any need of rearrangement.
2. All functions of similar character should be centralized and put under effective control. Thus, the purchasing activity, now so frequently allocated to all departments, should be put under central control. This would provide for enormous economies and proper control of stores.
3. From the expenditures for past years a uniform classification of expenditures adaptable to all departments should be introduced. This classification should be such that a clear distinction will be observed between expenditures for capital additions and for operating expenses. The additions to property accounts should of course, be controlled through the proper records related to the department appropriation accounts.
4. All city property should be inventoried and carried in properly grouped accounts on the balance sheet. By a proper relation between the capital expenditures chargeable to department appropriations, these capital accounts could be kept right up to date. All obligations and liabilities should be fully expressed in the accounts and a proper showing should be made of corresponding requirements and reserves.

5. All accounting should be under the control of one department.
6. The accounts should be kept on an income and expense rather than on a cash basis and should be fully controlled by a general ledger.
7. Unit costs and job costs should be established and standardized wherever possible.
8. Budgets should be functional as well as departmental and divisional.
9. Uniform monthly reports of all operations should be prepared for the city officials and the public.
10. The operating activities should not only be reflected in operating statements but should become equally evident through the changes in the balance sheet.

Test Yourself on Essential Points

1. Name and describe the principal groups in which the financial transactions of a municipality are summarized in its annual statement. (From American Institute Examination.)

2. Give three differences between the accounts of a municipality and the accounts of a commercial business. (From C. P. A. Examination.)

3. A village makes the following appropriations for the year 1926 and a tax is levied therefor:

Bond Redemption	$2,000.00
Bond Interest	800.00
Salaries	2,700.00
Contingent Expenses	500.00
Police	1,600.00
Poor	750.00
Care of Streets	1,200.00
Lighting	950.00
Education	3,000.00
	$13,500.00

How should the village books be opened for the year in accordance therewith? How should collection of taxes be recorded? How should disbursements against appropriations be recorded? (From C. P. A. Examination.)

5. Outline the principal points to be considered in the development of an efficient accounting system for a municipality.

Chapter XXXVII

MISCELLANEOUS AUDITS

Trustees' and executors' accounts—Educational institutions—Investments of an educational institution.

In the previous chapters, the procedure necessary for the effective audit of some well-known forms of business organization has been recommended. There are, however, special audits having certain peculiarities which must be covered in a work of this kind. It will be impossible to discuss all of these and we shall therefore confine ourselves to the following:

1. Trustees' and executors' accounts.
2. The accounts of educational institutions.
3. Club accounts.
4. The accounts of charitable institutions.
5. Hotel accounts.
6. The accounts of theaters.

Trustees' and Executors' Accounts

State Regulation of Estates. The accounting for estates is regulated by state law and the legal requirements are becoming more rigid. The result has been that public accountants are being asked more frequently to give advice on estate accounting and to examine the accounts of administrators and executors.

Administrators and executors in the technical sense are court officials, who have been chosen to close up the affairs of a decedent's personal estate. Their functions consist of the collection or conversion into cash of the personal property of the deceased, of the payment of his debts, and of the distribution of the remaining personal property according to either the provisions of intestate law or the will of the testator. The administrator is appointed by the court when there is no will. The executor is designated by the testator in the will and is approved by the court. The functions of the two are

identical. They both differ from a trustee, the latter being one who is given temporary or sometimes extended title to specific property which he must dispose of or hold (subject to the provisions of a trust indenture) for the benefit of another person designated in the law as the "cestui."

The auditor's first duty is to read the will (if there be one), to determine whether the will has been properly probated and whether the executor named therein has received the court's approbation and has filed a satisfactory bond if the state laws demand it. Wherever the state laws demand that the executor file an inventory of the personal property of the decedent, the auditor should obtain a copy of the inventory thus filed and compare it with the opening entries in the executor's accounts. The inventory filed with the court and the executor's books should specify the personal property in detail, and the values thereof should be based on an impartial appraisal. The debts should not be filed unless this is required by law, because the gross estate must not be diminished for the benefit of any particular creditors.

After having satisfied himself that all preliminaries required by law were complied with, the auditor must next determine, if possible, whether the entire personal estate is in possession of the executor. There may be assets in the hands of persons who have refused delivery thereof to the executor, and proper legal steps should appear to have been taken by the executor to gain possession of such assets. All cash of the decedent should be deposited in the bank in the name of the estate, and all other personal property must be preserved with the same degree of care as the executor gives to his own property.

The executor's duty is not to retain the personal property but to convert it into cash and to distribute the cash among the beneficiaries named in the will. The investigation of the conversion of the personal estate into cash or of its distribution in other forms, as provided by the

will, is of very great importance; the auditor must be sure that the realization from the sale of assets is complete, that no improper deductions have been made therefrom, and that property not converted is distributed on the proper basis.

The administrator has a preferred claim covering his own and the funeral expenses. These, as a rule, must be paid before the claims of creditors. All debts against the decedent at the time of his death come next, and must be paid in the order prescribed by law. If not so paid and if no further funds are available, the executor may become personally liable. The order of payment is generally as follows: first, debts due the national government; second, state and local taxes; third, claims reduced to judgment; and fourth, the claims of regular creditors.

The auditor may be engaged by either the estate or the executor. In either event his efforts should protect both, through a careful consideration of the assets to be accounted for, the claims to be liquidated, the expenses to be paid, and the distribution of the residuum to the legatees, or heirs. Legacies must not be paid until the time specified by the court or until there is complete assurance that all creditors have been fully satisfied. After the executor has performed all these various duties, he must present his final accounting to the court. As it is generally the final accounting which is submitted for audit, it is of the very greatest importance that the audit be quite detailed and thorough. The final accounting is the basis of the court's order for the distribution of the estate.

An estate in trust generally consists of real or other property conveyed to an individual or organization as trustee. The trustee must preserve the property intact and must dispose of its income as provided by the trust agreement. The most important task of the auditor is, therefore, to ascertain that the principal remains untouched, that the distinction between principal and

income be studiously observed in all the trustee's activities, and that this distribution be properly recorded in the books. This is not always so simple. For example, a dividend received after the testator's death may be either principal or income. If declared before the date of death, it is principal; if after that date, it is income, the date of the dividend declaration and not its receipt being the governing factor.

Not only must all the assets held by the trustee be fully examined and proved (by actual count in the case of securities), but the income therefrom must be fully accounted for in detail. All expenditures must be accompanied by proper vouchers. The commissions taken by the trustee on net increases of investments (through reinvestments) and for distributing and accounting for the income, must be proper and in accordance with the law or the will as the case may be.

The nature of trust investments is fixed by law. As a rule they are limited to real estate mortgages, approved first-mortgage railroad bonds, and government securities. Losses ensuing from illegal investments must be borne by the trustee. The auditor must also ascertain that the trust funds are kept separate and distinct from the trustee's personal funds and that they are separately accounted for.

During the administration of a trust the following are regarded as reducing principal:

1. Premiums on securities purchased. (These should be amortized during the life of the securities and a portion of the interest received on the securities set aside to offset the annual premium amortization).
2. Losses ensuing from the liquidation of approved investments.
3. Losses of property which are beyond human control or which cannot be compensated for by insurance.
4. Shrinkages in values due to obsolescence which could not be foreseen.

Accretions to principal are occasioned by the following factors:

1. Increases in the values of real property due to the passing of time.
2. Profits on the sale of investments.
3. Discounts on securities purchased.

Accounts of Educational Institutions

Colleges and Universities. Universities either are privately endowed or are state institutions. The accounts need not vary, however, except with reference to the classification of income. Both derive funds from matriculation, tuition and laboratory fees, and in some cases from dormitories and sales of various products; but these classes of income form a relatively small portion of the entire income of most universities and colleges. The great bulk of income is derived either from funds provided by state taxation or national government support in the case of state universities, or from interest on investments in the case of privately endowed universities.

We have already described very fully the accounting or auditing procedure necessary for appropriation accounts in connection with municipalities; the appropriation accounts of universities are constructed in exactly the same way. As certain disbursements for departments must come from specific funds, universities also keep fund accounts. The withdrawals from the various funds (through voucher) must agree at all times with the voucher charges to the departmental appropriation accounts. Universities, like municipalities, keep account of their contracts and open market orders, both being regarded as encumbrances against the departmental appropriations.

Vouching of Disbursements. In auditing university accounts, the largest, and to a certain degree, the most important task is the vouching of the disbursements; the vouchers must not only be withdrawals from the proper

funds and charges to the proper department appropriations, but they must be charged to the proper account classification under each appropriation account. Some of the leading state universities of the Middle West recently adopted (with necessary modifications to meet local conditions) the following uniform classification of expenditures, which provides for both an organization (functional) and a commodity or service distribution:

Account Classification

1. Administration and General.
   - (a) Executive Offices.
     - Board of Trustees.
     - President.
     - Vice President.
     - Business Office.
     - Registrar.
     - Legal Counsel.
     - Adviser to Foreign Students.
     - Council of Administration.
     - University Senate.
   - (b) General Offices.
     - Dean of Men.
     - Dean of Women.
     - High School Visitor.
     - Information Office.
   - (c) General Accounts.
     - Publications.
     - Lectures.
     - Concerts.
     - Convocations.
     - Receptions and Social Functions.
2. Instruction and Research.
   - Liberal Arts and Sciences.
   - Engineering.
   - Agriculture.
   - Graduate School.
   - Medicine.
   - Dentistry.
   - Pharmacy.
   - Commerce.
   - Law.
   - Music.

Library Science.
Summer Session.
3. General Departments.
Library.
Physical Training for Men.
Physical Training for Women.
Military.
Health Service.
Water Survey.
4. Physical Plant Operation and Maintenance.
Administration.
Building Operation.
Building Maintenance.
Power Plant.
Telephone Exchange.
Grounds.
5. Land, Buildings, and Plant Extension.
Purchase of Land.
Land Improvement.
New Buildings and Additions.
Service Plant Extension.

SERVICE AND COMMODITY CLASSIFICATION

1 Expense (Revenue Expenditure).
11 Salaries and Wages.
111 Instruction and Research.
1111 Professors (including Deans' instruction).
1112 Associate Professors.
1113 Assistant Professors.
1114 Associates.
1115 Instructors.
1116 Assistants.
1117 Lecturers.
1118 Fellows and Scholars and Student Assistants.
1119 Technical Assistants and Service Men.
112 Administration.
1121 Officers.
1122 Clerical.
113 Lectures and Entertainments.
114 Labor and Unclassified Service.
12 Material, Supplies, etc.
121 Communication Service.
1211 Postage.
1212 Telephone and Telegraph.

122 Stationery and Office Supplies.
123 Publications.
124 Traveling Expense.
125 Freight, Express, and Cartage.
126 Repairs.
1261 Furniture and Apparatus Repairs.
1262 Building Repairs.
1263 Land Maintenance.
127 Supplies for Instruction.
128 General Supplies.
1281 Building Supplies.
1282 Farm Supplies.
129 Sundries.
1291 Office.
1292 General.
2 Equipment (Capital Expenditure).
21 Equipment.
211 Apparatus.
212 Furniture and Office Equipment.
213 Books.
214 Machinery and Tools.
215 Livestock.
216 Specimens and Collections.
22 Land and Buildings.
221 Land and Land Improvements.
222 New Buildings and Additions.

Verification of Income. The income provided for state universities from state funds, derived from taxation, can readily be verified from the legislative appropriation bill and the balances in the various state funds by communicating with the state treasurer's office. Tuition fees can be proved in totals from the register of enrolled students in the catalog or from the published student directory, after making the necessary provisions for scholarships, fellowships, and reduced fees. Diploma fees may be verified from the list of graduates and recipients of higher degrees as shown in the university catalog. Laboratory fees may be accounted for through the enrollment of students in courses where laboratory fees are charged.

Departmental sales can be verified by reference to pro-

duction records (in the case of agricultural departments) or to the sales data kept by the departments; the income from departmental sales for the colleges of agriculture is generally credited to the departmental appropriation accounts. As a rule, therefore, the departments themselves may be relied upon to account quite fully and accurately for the income from their own sales.

Investments. In privately endowed schools, where the income is derived largely from investments, the investments themselves must be verified by actual count and inspection (in the case of securities), by reference to the deeds to property, and by inspection of the agreements with donors. The income from these various investments and properties must be verified in the usual way as heretofore outlined.

What has been said regarding the opportunity for improvement in business procedure and accounting systems of municipalities, may be applied with the same force and in substantially the same way to educational institutions. The auditor will often find opportunity to render valuable services along these lines.

TEST YOURSELF ON ESSENTIAL POINTS

1. How are the accounts of an estate regulated by state law?
2. Outline the method of verifying the accounts of an executor.
3. What distinction is there to be made in the accounting plan of educational institutions over that of a trading business?
4. How would you verify the income of a state university?

Chapter XXXVIII

MISCELLANEOUS AUDITS (Cont'd)

Club and hotel accounts—Income from rooms—Guest registration—Income from restaurant—Special accounts to be considered in a club—Accounts of charitable institutions—Accounts of theaters.

Club and Hotel Accounts. Club and hotel accounts are so similar in many respects that they may be considered together. A club is virtually a hotel for members only, with certain additional social features not offered by hotels. Moreover the hotel charges are generally collected in cash as the guest departs, whereas the club extends credit to its members.

The most important thing an auditor should do when called in to audit clubs or hotels, is to examine thoroughly the system of accounts in use. The larger hotels have provided effective safeguards for their accounting. This is essential, since most of their income is in cash. The revenue of hotels may be conveniently divided into income from rooms, from restaurants, from cigar counters, and from rents.

The income from rooms can be verified from a number of sources. In the first place the guest register contains the names of all who have in any way utilized the hotel facilities. Consequently, for each registration, there should be a charge on the room ledger or a cash entry for meals, if no room was occupied. Or, if the guest had an account, a charge should appear in the accounts receivable ledger. A comparison of all these charges with the guest register is the most direct check on room revenue. It should, however, be supplemented by comparing with the guest register the housekeeper's record of rooms occupied and vacated.

Guest Registration. Some hotels require their guests to register on cards, the cards, at one and the same time, serving as a ledger for current charges against the guests

and as the file for occupied rooms (the room tray). Such cards are numbered consecutively and each number must therefore be fully accounted for. Each card provides also for charges made to the guest's account covering telephone calls, meals, laundry, etc. The card tray is in reality a bookkeeper's ledger. When the guest departs, he calls for his account. The bookkeeper foots up the amounts as indicated by the card, passes it over to the cashier, and instructs the guest to pay his bill at the cashier's window. The card is then stamped paid, the amount collected is entered in the cash book (properly distributed and classified), and the cashier then returns the "paid" card to the bookkeeper to be filed by number. It is to be noted that when the guest originally registers on the card, a carbon copy may be obtained of his registration, which may be used for the mail tray or room tray if it is found undesirable to combine the room tray with the bookkeeper's file. It is essential that the collection of cash be entirely divorced from the activities of the desk (or registry) clerk and the bookkeeper.

Income from Restaurant. Income from the restaurants may be verified by checking the cash and charge tickets (which should be consecutively numbered) turned in by the restaurant cashier against the chef's records of meals prepared and served. The entire restaurant operations must also be related to the inventories of food supplies. Income from cigar counters should be verified from the cash registers and from the commissary records of cigars turned over to the cigar counters.

Many hotel companies sublet certain spaces (especially on the ground floor) for stores. The auditor must examine the leases and verify the income from rents in accordance with the lease provisions.

The inventory accounts must be carefully examined and all purchases evidenced by proper vouchers. The pay rolls must be fully checked, the accounts receivable scrutinized and, if necessary, circularized for confirmation, and the depreciation rates on furniture, linens, glassware, etc., inspected.

Club Accounts

Club accounts, as a rule, are not as well safeguarded as hotel accounts, and the dangers from peculation are much greater. Wherever possible the cashier's functions should be entirely separated from the bookkeeping. Members should be requested to pay their bills by check rather than in currency, and all charge or sale forms should be numbered consecutively. Membership dues may be verified from membership rolls and from the minute book wherein the names of new members are indicated. Revenue from rooms should be tied up with the housekeeper's record of rooms occupied. As in the case of hotels the income from restaurants should be reconciled with the inventory records and proper depreciation provided for club-room furniture, club building, and other property.

Accounts of Charitable Institutions

Charitable institutions are either public or private. Institutions like orphanages, asylums, and hospitals operated by the states are generally audited by representatives of the state administration. State institutions derive their income almost entirely from government appropriations which are more or less limited as to their use. In auditing such accounts the charges to the various appropriations must be carefully inspected and they should be evidenced by properly authorized vouchers. The income from pay patients should be checked from the registration records.

Privately endowed charitable institutions are supported by donations or as in the case of hospitals by donations and income from patients. Donations may usually be verified from published lists of donors or by corresponding with the donors themselves whenever the published lists do not specify amounts and there is a suspicion of

irregularities. Many private charities keep their accounts on a cash basis, with the result that their operations are not properly recorded. The books should show the entire revenue earned and the actual cost of operations.

Theaters

As the income of theaters is practically all cash, the audit of the Cash Account is of the very greatest importance. Because of the great amount of detail, the auditor cannot be expected to audit the Cash Account in full. The treasurer is expected to do this detail work. It will be necessary, however, to make a number of exhaustive tests.

In the regular theaters the tickets presented by the audience are torn by the doorkeeper and the seat coupon is retained by the spectator. The part retained by the doorkeeper bears the same seat number and date as the seat coupon. The canceled tickets should be retained for a period so as to afford an opportunity for either external or internal audit at some future time, and they should be arranged by dates and in groups under each date according to the various prices of different sections of the house. The revenue reported for each day should equal the amounts determined by multiplying the number of tickets in each group by the group rate.

All tickets should be numbered so that the entire capacity of the house can be accounted for; the unsold tickets must supply the numbers unaccounted for by the canceled tickets. Allowance must, of course, be made for complimentaries, but all complimentaries must be properly authorized by the management.

The income from ticket sales in moving-picture or vaudeville houses, where the strip, or tape ticket is used, can readily be verified. The numbers used during an entire season should be consecutively numbered. If such a plan is followed, the entire income can be verified by taking the number of the first unused ticket from the

strip or roll of strip which was used last in the season. This gives the total number of tickets sold, and is to be multiplied by the ticket rate—or rates, if there are various strips for different sections of the theater. There may be a free list, and proper deduction should be made therefor. The auditor must, however, secure the proper authorization for any free list.

The admission charges of all theaters (except where there are personal guarantees), should be ample to provide for all expenses of management and operation, and for a profit. The auditor should see that proper provision has been made for depreciation and all accrued expense (at the end of any period) and that nothing which rightfully belongs there has been omitted from the operations of a period.

Test Yourself on Essential Points

1. State what you consider to be the most important special problems arising in the following classes of audits and how you would deal with such problems:
   (a) Clubs and institutions.
   (b) Theaters.
   (c) Hotels.
   (From American Institute Examination.)
2. State how you would verify the income of a hotel?

Chapter XXXIX

INVESTIGATIONS

Fire Losses

Scope of investigations—Value of public accountant in case of a fire loss—Actual case illustrating procedure for determination of inventories at date of fire.

The work of the professional auditor is not confined entirely to that of balance sheet or detail audits of various types of businesses. He is frequently called upon to make special examinations or investigations. In some investigations a complete detailed audit is required; in some, a balance sheet audit is essential, and in others, only special phases of the business are examined sufficiently to obtain the desired results.

Fire-Loss Adjustments. Most business concerns anticipate the possibility of a fire and, therefore, insure their property accordingly, but a very few ever consider just how they will collect their insurance, in case of a fire. The auditor can be of real service to his client in the adjustment of claims. It has been proved in practice that in case of loss of merchandise by fire, a balance sheet prepared by a reputable public accountant has been of considerable value in establishing the correct amount of the insurance claim.

Case of Fire-Loss Adjustment. On March 24, 1926, the merchandise stock of a retail dealer in women's wear was destroyed by fire. It was, therefore, necessary to determine the value of the stock at March 24, 1926, since no perpetual inventory system was in use. The services of a well-known firm of certified public accountants was sought to compute the value of merchandise destroyed by the fire.

The computation was based upon the gross profit percentages revealed by the operations for the year 1925,

which may be said to reflect the conditions, also, during the short period from January 1, 1926, to March 24, 1926. As a result of this investigation the auditor submitted statements as follows:

1. Determination of gross-profit percentages for previous year.
2. Determination of cost of sales for the current year to date of fire.
3. Determination of inventory at date of fire.

The first step the auditor takes in an investigation of this nature is an examination of the methods of bookkeeping in force, and the method of keeping records of stock. If no perpetual inventory is maintained, it is necessary to calculate the amount of the loss upon the usual basis; that is, to take the last recorded inventory, add purchases to date of fire, and deduct cost of goods sold, the result being the stock on hand at time of fire.

Determination of Gross-Profit Percentages. As a result of examining the inventories at January 1, 1925, the auditor made tests of their valuations and included therein stock held on deposit. The methods of accounting for purchases and particularly the purchase discounts were tested. The freight on purchases during the year 1925 was also carefully examined and an equitable distribution was made to the general classes of goods handled. After testing the inventories at December 31, 1925, and the sales distribution, the figures in the accounting records and also those shown on the income tax report were accepted. The auditor then prepared the following statement to determine the percentages of gross profits to sales:

Determination of Gross-Profit Percentages for Year 1925

	Millinery	Dresses, Skirts, Coats, and Suits
SALES	$118,721.72	$290,360.57

COST OF SALES:		
Inventory, January 1, 1925	$ 5,915.65	$ 63,269.84
Purchases	61,415.10	212,457.55
Express Inward	610.27	4,053.49
Totals	$ 67,941.02	$279,780.88
Less—Discount on Purchases	3,588.57	17,724.72
	$ 64,352.45	$262,056.16
Deduct — Inventory, December 31, 1925	5,622.00	71,675.94
Total Cost of Sales	$ 58,730.45	$190,380.22
GROSS PROFIT ON SALES	$ 59,991.27	$ 99,980.35
PER CENT OF GROSS PROFIT TO SALES	50.53	34.43

COST OF SALES TO DATE OF FIRE. These percentages were then applied to the sales of 1926 to the date of the fire and the gross profits were determined as follows:

DETERMINATION OF COST OF SALES
FROM JANUARY 1, 1926 TO DATE OF FIRE

	Millinery	Dresses, Skirts, Coats, and Suits
SALES	$18,930.76	$65,029.36
Less—Allowances and Discounts	118.49	854.35
NET SALES	$18,812.27	$64,175.01
GROSS PROFIT ON SALES. (Based on percentages in previous statement)	9,505.84	22,095.46
COST OF SALES (to date of fire)	$ 9,306.43	$42,079.55

Determining Inventory at Date of Fire. After having found the cost of sales of the current period to the date of the fire, the auditor's next step is to ascertain the total cost of merchandise to be accounted for during the same period. Deducting from the amounts so obtained the cost of sales, the balance is the estimated value of the inventories at the date of the fire. As a result of this procedure the following statement was prepared from the data found in the accounting records.

DETERMINATION OF INVENTORY AT DATE OF FIRE MARCH 24, 1926

	Millinery	Dresses, Skirts, Coats, and Suits
Inventories, January 1, 1926	$ 5,622.00	$ 71,675.94
Purchases	10,211.07	48,397.77
Express Inward	85.76	851.66
Totals	$ 15,918.83	$120,925.37
Less—Purchase Discounts	785.24	4,458.12
	$ 15,133.59	$116,467.25
Deduct—Cost of Sales (as per Former Statement)	9,306.43	42,079.55
INVENTORY AT DATE OF FIRE	$ 5,827.16	$ 74,387.70

The cost of goods sold is ascertained by deducting from the sales the average gross profit realized in prior periods. Fire insurance adjusters often take advantage of the business man whose records are poorly kept. Consequently he is usually forced to settle his insurance claim upon a basis satisfactory to the adjuster. If, however, the business man's last inventory has been certified to, he can refuse to compromise and insist upon the full amount of his claim computed in the manner set forth in this case.

Determining Values by Classes Important. In case a business is handling more than one line of goods, reliable values of the loss by fire can be obtained only by applying the average per cent of gross profit to sales of each class, to the sales by the same classes for the period from the beginning of the year to the date of the fire. In the case which has just been shown the total loss by fire is summarized as follows:

Millinery	$ 5,827.16
Dresses, Skirts, Coats, and Suits	74,387.70
Total Loss	$80,214.86

If the auditor in this case had calculated the estimated loss of merchandise destroyed by fire in total, disregarding the departmental classification of sales, purchases,

and inventories, there would have been a difference of $846.73 in the values representing the loss. The percentage of gross profit to sales for the year 1925 would have been stated as 39.1, computed as follows:

Sales, Year 1925	$409,082.29
Cost of Sales	249,110.67
Gross Profit on Sales	$159,971.62
PER CENT OF GROSS PROFIT TO SALES	39.1

The amount of merchandise to be accounted for at the time of the fire and the cost of sales for the period from January 1 to March 24 would be calculated thus:

Inventories, January 1, 1926		$ 77,297.94
Purchases from January 1 to March 24, 1926		58,608.84
Express Inward		937.42
Total		$136,844.20
Less—Purchase Discounts		5,243.36
TOTAL MERCHANDISE TO BE ACCOUNTED FOR, MARCH 24, 1926		$131,600.84
Sales, January 1 to March 24, 1926	$82,987.28	
Deduct:		
Gross Profit (39.1%)	32,448.03	
Less—Cost of Sales for Period		50,539.25
VALUE OF GOODS DESTROYED BY FIRE		$ 81,061.59
Loss Computed by Departments (as above)		80,214.86
Difference in Computations		$ 846.73

Since various classes of merchandise carry different percentages of gross profit to sales, it is important to ascertain the value of the stock destroyed according to the different lines of goods to establish the correct amount of an insurance claim to be passed upon by the insurance adjusters.

If perpetual inventories are maintained, they usually furnish the best possible evidence of quantities. In some cases where the quantities of goods sold, purchased, and on hand, are available, the quantities of each class of merchandise may be very approximately determined at the date of the fire. If there are no perpetual inventories,

resort is usually had to the gross-profit method. The values thus ascertained may be subject to scaling down by the adjuster for depreciation in the value of goods which are shopworn, damaged prior to the fire, or out of style. In this connection it is important to note the effect on the estimated inventory valuation, if the inventory at the date of the last closing was marked down because of deterioration.

Test Yourself on Essential Points

1. Distinguish between a balance sheet-audit and an investigation.
2. The entire stock on hand of a mercantile concern is destroyed by fire. The accounting records are saved. How would you ascertain the amount of loss to claim against the insurance company? (From C. P. A. Examination.)

Chapter XL

INVESTIGATIONS (Cont'd)

Partnership Dissolution

Methods of dissolving a partnership—Dissolution by the partners—Accountant's work in the investigation—Illustrative problem and solution—Dissolution by law—Dissolution by court order.

Partnerships may be dissolved in several ways:

1. By the act of the partners.
2. By law.
3. By court order.

In all of these three types of dissolution, different influences and factors are at work, so that an audit to determine partners' equities, or the rights and claims of others, would vary in its scope and nature with each type of dissolution.

Dissolution by Partners. Self-imposed dissolution may occur as a result of a mutual agreement among the partners, or because the articles of co-partnership specify a definite period of partnership existence. Partnerships formed to perform particular transactions end when the transactions have been completed, these latter being much like joint ventures.

In most states, the withdrawal of a partner, or the sale of his interest, dissolves the partnership. In this way, the will of one partner suffices to break the partnership, although remaining partners may recover damages for breach of contract.

A partnership is considered voluntarily dissolved, when a new partner is admitted even though the articles of co-partnership provide for some definite admission at a certain time. Naturally in such cases the firm will go on, but legally the old partnership is considered dissolved and a new partnership is in existence.

An assignment in trust, by a partner of his interest, effects a dissolution in most states. A dissolution also occurs through an involuntary assignment in case of the partner's bankruptcy. In such event, the court may sell the partner's interest thus dissolving the partnership.

The Accountant's Work in Investigations. The public accountant is often called in at the time partnerships are voluntarily dissolved, and his assignment usually consists in establishing and determining the assets and liabilities of the partnership and the respective equities of the partners in the net worth. If there are definitely written articles of co-partnership, it becomes the auditor's duty to refer to these and to guide his conclusions and findings by the stipulations contained therein.

Illustrative Problem. The following facts are given in a case to show how the public accountant must attack his problem:

1. A. B. Company was organized January 1, 1921, as a partnership by A and B to which each contributed $20,000.00 capital; the existence of the partnership was limited by the articles to a period of five years, that is, the partnership was to be dissolved at the close of business, December 31, 1925. If at that time the business had proved to be a success, it was to be reorganized as a corporation.

2. The articles of copartnership among other things contained the following stipulations:

(a) Profits and losses were to be shared equally at the end of each year, but the partners were each to contribute 10 per cent of their profits to a special capital reserve.

(b) A's salary was fixed at $6,000.00 a year and B's at $4,000.00. These might be drawn out fully, at intervals during each year, or they might be left in the business to form part of the partners' capital accounts. Transfers to capital accounts were to be made at the close of each year from the partners' salary-credit accounts. No interest was to be allowed on the salary-credit balances until they were transferred to capital account at the end of the year, each partner then exercising the option of withdrawing salary balances or of transferring the balances to capital.

(c) Interest at the rate of 6 per cent was to be paid to partners at the end of each year, and was to be treated as an expense in the determination of the net profits. Interest was to be actually paid and was not to be credited to the partners' capital accounts. Partners could, at any time, however, contribute additional capital, if needed in the business, or they were free to make loans to the firm at a 6 per cent interest rate. Interest on loans was also to be actually paid and was not to be credited to capital accounts. The interest on capital accounts was to be computed on the average obtained from monthly balances, for each year.

(d) Withdrawals of partners' capital during each year were limited to 10 per cent of each partner's capital account at the beginning of each year, unless a loss had occurred in the prior year. In the latter event there were to be no capital withdrawals during the year immediately following.

(e) At the expiration of the partnership agreement, the equities of the partners were to be established, the goodwill (if any) computed, and the interests of each partner in a new corporation to be fixed, it being assumed that the new corporation was to be entirely controlled and owned by A and B.

What would an auditor, or public accountant, who was engaged to determine the rights and equities of the partners, the claims of outsiders, the goodwill of the business, and the partners' positions in the new corporation, all as of December 31, 1925, be required to do?

Solution to Problem. Without giving any figures, this question would be answered as follows:

1. The articles of copartnership would have to be carefully read and all of its essential provisions comprehensively interpreted with the aid of the contracting parties.

2. The amount and value of the capital originally contributed would have to be established. In this case, the auditor would have to assure himself that each partner contributed $20,000.00. Capital contributions are not always in the form of actual cash. They may be made in valuable properties or rights upon which a capital value has been set. In cases of dispute as to values, the auditor may be called upon for an opinion as to values that have been contributed in other forms than cash. This opinion may be concerned with either tangible or intangible property.

3. If profits were made during each year of the partnership, the auditor would have to make sure that 10 per cent of each partner's allotted profits each year was transferred to a special capital reserve. At the end of the period of partnership the balance in this reserve would be closed in equal amounts, to the partners' capital accounts.

4. The salaries stipulated would have to be checked, and since the articles so state, the auditor would have to make sure that any salaries not drawn were credited to partners' capital accounts at the end of each year only, and that no interest was allowed on salaries not withdrawn until they became part of the capital accounts at the beginning of the ensuing year.

5. The interest computed on the partners' capital accounts would have to be verified, and should show as an expense at the end of each year before divisible profits were computed. The auditor would have to satisfy himself that the interest was actually paid and not credited to capital accounts. The rate of interest, of course, and the amount thereof would also have to be verified by establishing each partner's annual investment average from each year's monthly balances.

6. Assurance would have to be had that capital withdrawals (that is the partners' drawing accounts), did not exceed 10 per cent of each partner's capital account as it stood at the beginning of each year. Drawing accounts are generally considered as representing withdrawals of capital and should not be confused or merged with salaries taken by the partners. If there were any net losses during any of the years, the auditor would assure himself that there were no withdrawals during the following year and, of course, that the net loss was charged equally against the partners' capital accounts.

7. If goodwill had developed as a result of net profits in excess of a normal return on the partners' investment, that goodwill would be computed in the way most expressive of the particular business involved and would be set up on the books at the end of the partnership term by charging Goodwill Account and crediting the partners' capital accounts in equal amounts.

8. The assets and liabilities of the partnership, at December 31, 1925, would have to be definitely established by the usual processes of auditing already described. The auditor should set up his own bill as one of the liabilities or else provide for its payment through the partners individually. Although a partnership, as such, pays no federal income tax, the auditor should call for the partnership returns which are required by law, and the returns of the individual partners who include partnership profits, and interest paid them (as well as salaries) on their individual income-tax returns. These reports should all be compared and examined as to their accuracy and, at the same time, the auditor must make sure that there are

no additional assessments arising from partnership profits and income, and that the amounts reported for Federal taxation are fully in accord with the Federal Revenue Acts.

9. After the auditor had fully satisfied himself as to the profits of all the years and the propriety of the capital accounts, he would prepare a final balance sheet of the partnership under date of December 31, 1925. This balance sheet would disclose all of the assets and liabilities of the partnership and the partners' capital accounts, the latter representing the respective equities of the two partners in the business.

10. If asked to do so, the auditor would finally close the books of the partnership in the following manner. We will assume that the net assets (assets minus liabilities) were being transferred to a new corporation which we may call the A. B. Corporation and that the total assets were $150,000.00, liabilities $50,000.00, A's capital $40,000.00, and B's capital $60,000.00:

JOURNAL ENTRIES CLOSING PARTNERSHIP ACCOUNTS

(1)

A. B. Corporation	$100,000.00	
Liabilities (detailed)	50,000.00	
Assets (detailed)		$150,000.00
To charge A. B. Corporation with net value of business sold to it December 31, 1925.		

(2)

A Capital Account	$ 40,000.00	
B Capital Account	60,000.00	
A. B. Corporation		$100,000.00
To credit A. B. Corporation with A's and B's Capital Accounts, A and B having accepted capital stock of A. B. Corporation in payment of sale of their business to the corporation.		

* * *

11. The books of the corporation (assumed capital stock $150,000.00) would be opened as follows:

(1)

Unissued Capital Stock	$150,000.00	
Authorized Capital Stock		$150,000.00
To record total capital stock authorized.		

(2)

Subscriber's Accounts:		
A	$ 40,000.00	
B	60,000.00	
Unissued Capital Stock		$100,000.00
To record subscription of A and B to Capital Stock of Corporation.		

(3)

Sundry Assets	$150,000.00	
Sundry Liabilities		50,000.00
Subscribers Accounts:		
A		40,000.00
B		60,000.00
To record payment of Capital Stock Subscriptions of A and B by means of net assets of $100,000.00 transferred by them to the corporation.		

Dissolution by Law. A partnership is dissolved by operation of law—

1. At the death of a partner.
2. By the adjudication of a partner or the firm, as bankrupt or insolvent.
3. By the business of the firm becoming unlawful.

In the case of dissolution by the death of a partner, the auditor called in to adjust affairs will naturally determine the equities of all the partners in much the same way as in voluntary dissolution, but, in addition, he must know and observe a number of legal requirements. He must know that the deceased partner's share of real estate owned by the partnership, in many states, passes to the heirs of the deceased subject to a trust in favor of the partnership until the debts of the latter are paid. He should also know that a provision in the articles of agreement providing for a continuation of the business at the death of a partner creates a new partnership and does not really continue the old one. Again, the executor of a deceased partner's estate cannot be compelled to take the deceased partner's place even though this may be provided in the will of the deceased. Very often, of course, a new partnership goes on with the real estate

owned by the old partnership, if the executor of the deceased and the court can be satisfied with a money settlement. If the real estate must be sold, the same effect may be gained by having a bona fide sale of it made to the surviving partners. It can readily be seen that the auditor must be equipped with some knowledge of the inheritance laws of his state when death dissolves a partnership.

Dissolution by bankruptcy or insolvency of a partner also has its legal angles, especially since such a dissolution occurs without notice to creditors. Moreover, dissolution occurs when the firm makes an assignment in favor of its creditors, and in some jurisdictions when one partner makes such a general assignment. Not only must the rights of outside creditors be fully included in the auditor's purvey of things, but the individual partner's bankruptcy in many instances will affect the other partners' equities, especially when the personal relations between the partners have been quite intimate and inter-related.

Where partnerships have been dissolved because their business was no longer lawful, claims of various kinds may come to the fore, the successful outcome of which may result in monetary advantage to or recovery for the partners. Thus the Federal Prohibition Act has put many partnerships out of business. In cases where wholesale liquor dealers and wineries built up a considerable goodwill by means of product trade names and labels and yet these firms paid heavy Federal income taxes before prohibition, it was possible to establish claims against the Internal Revenue Department (income-tax unit) for the amortization of the goodwill which the Prohibition Act suddenly destroyed, and to apply the amortization against the income reported in past years for taxation. The Prohibition Act had a confiscatory effect upon many firms engaged in the liquor business.

Dissolution by Court Order. A partnership may be dissolved by a court in equity, an accounting ordered, an injunction against the disposition of assets issued, and a receiver appointed in cases where the partnership is guilty of intentional misconduct, has been fraudulently formed, where one of the partners is insane, or where circumstances exist which show that the partnership cannot hope to continue successfully.

If fraud is involved in the formation of a partnership, and the auditor is called in, it is at once apparent that it becomes his task to expose the fraud and to disclose the methods used in its perpetration. He may work at the direction of the court and thus represent all interests involved, or he may be retained by a damaged party, in which event he must know how to establish the rights and claims of his client before the court or as the basis of civil suit against the wrongdoers in the transaction. A very thorough knowledge of partnership law, the Bankruptcy Act, inheritance laws, and frauds is a necessary equipment of an accountant who expects to deal extensively with partnership dissolutions.

Test Yourself on Essential Points

1. State three ways in which a partnership may be dissolved and outline the procedure in each case.

2. A and B trading in partnership decide to admit C as from January 1, 1926. They agree with C as follows:

C is unable to contribute any tangible assets as his capital investment, but agrees to allow his share of the profits to be credited to his capital account until he shall have one-fifth interest. C is to share profits and losses to the extent of one-fifth.

C is to receive a salary of $3,000.00 per annum, payable monthly in addition to his share of profits.

During the six months ended June 30, 1926, the business has sustained unusual losses, and it is decided to dissolve the partnership.

The balance sheet at that date is as follows:

Assets		Liabilities	
Cash	$ 500.00	Accounts Payable	$12,500.00
Accounts Receivable	12,500.00	Capital:	
Merchandise	5,000.00	A	10,000.00
Furn. & Fixt.	1,500.00	B	5,000.00
Goodwill	2,500.00		
Deficit:			
Being loss on trading for six months	5,500.00		
	$27,500.00		$27,500.00

A public accountant has been asked to make an investigation. C is ascertained to be worthless.

You are required to outline what steps must be taken by the accountant in the conduct of this examination to establish the status of each partner.

Chapter XLI

INVESTIGATIONS (Cont'd)

Fraud and Defalcation

The commercial crime situation—Methods of defalcation by cashiers—Credit frauds—Stock frauds.

The detection of frauds and defalcations was at one time conceived to be almost the sole function of the public accountant, and in spite of its recent relegation to the background, because of the ever-increasing scope of the public accountants' activities, it is still an important phase of professional work. In fact, it may be said that, because the accountants' activities have been largely centered about the more or less constructive needs of business, too little attention has been given to the problem of business frauds and financial defalcations. Public accountants, no matter what the basis of their engagement may be, should always keep an eye wide open for the detection of irregularities and frauds. The commercial crime situation in the United States is deplorable, and the resultant losses are almost staggering in amount.

In a recent bulletin published by the American Institute of Accountants,[1] it is stated that fidelity and surety company officials estimate the annual losses from financial crimes at a total of $3,000,000,000.00—"a sum comparable to the value of the entire annual imports of the nation." The same bulletin says:

> More than one-half of these losses are of especial interest to practicing accountants because of the relation that their work bears to the prevention and detection of the losses. These losses, amounting to $1,600,000,000.00, are as follows:

Losses from embezzlements and forgeries	$ 200,000,000.00
Losses from credit frauds	400,000,000.00
Losses from stock frauds	1,000,000,000.00

[1] *The Crime Tendency*—Letter-Bulletin 2, published by the Bureau of Public Affairs, American Institute of Accountants, 135 Cedar St., New York, October 1, 1924.

Although the losses from embezzlements (defalcations) and forgeries amount to a considerable sum, they are, according to the above estimates, only 12½ per cent of the $1,600,000,000.00 and less than 7 per cent of the total $3,000,000,000.00 referred to. Nevertheless, the business man and the accountant have focused most of their attention on these relatively smaller losses, because—

1. They are, as a rule, more or less spectacular.
2. They generally concern some individual in whom trust has been imposed, thus bringing the human factor clearly into the limelight.
3. They are more readily exposed and traced.
4. In many instances, they are recoverable because of insurance protection.

Defalcation by Cashiers. We cannot here describe all of the tricks and methods used by embezzlers and how these may be detected. The following are descriptive of the usual methods:

1. When receiving cashier or teller, who does not have access to any other books of account than his own cash book, does not deposit all receipts in bank.

If he has entered all moneys received by him in his cash book and all receipts are supposed to be deposited, the cashier's shortage can be detected by comparing the bank statements of deposits with the totals in the cash book, assuming, of course, that the totals are correctly footed. This is a pure case of theft and not of fraud, because no alterations are made on the books. Had the totals in the cash book been altered or individual amounts received been reduced, the case would be one of fraudulent theft.

2. Where a cashier in charge of the receipts cash book only, withholds amounts but makes no entry of them at all.

In this case the deposits per bank statements and the cash-book totals would agree, and if all receipts

came directly to the receiving cashier without a preliminary tally, from some one intrusted with the opening of the mail, an embezzlement of this kind would be somewhat difficult to uncover. If all receipts were from charge accounts, the receipts withheld would not appear and the customers' accounts would remain open for an undue length of time. Discovery of a defalcation of this kind could be effected by means of the monthly statements mailed to customers, assuming that the mailing of these statements was a function entirely independent of the cashier's activities. The customers would naturally draw attention to the fact that their accounts had been paid. But suppose that the cashier withholds amounts coming entirely from cash sales. If there are no sales slips in such cases the embezzlement can only be disclosed by means of a careful inventory check, because an inventory adjustment would surely have to be made for the goods sold but never accounted for. To safeguard against methods of this kind, a system should be invoked making cash sales without a cash slip or ticket impossible and by having all cash slips consecutively numbered. If, at the same time, it is required that all receipts be deposited intact in bank each day, and that all mail receipts be listed before going to the cashier, a very effective control over the cashier may be obtained.

3. Where a cashier takes money at one date to cover up a shortage of a previous date or dates.

Under this plan the cashier would not enter the cash at the time received but would defer entry until some other collection could be conveniently taken. Suppose $100.00 in currency is received on June 3, from John Smith, a customer and is part of $1,000.00 received that day from all customers. The cashier enters $900.00 of the receipts properly in the cash book, and deposits that amount; he keeps the $100.00 from John Smith. On June 8 the cashier receives $1,200.00, and feels that he

must now account for the Smith collection. He, therefore, enters $100.00 as received from Smith on June 8, but withholds $200.00 received in currency from Sylvester Jones. He deposits in bank $1,100.00, his cash book entries being influenced by the following factors:

Receipts June 8	$1,200.00
Less—Jones collection	200.00
	$1,000.00
Add—Smith collection of June 3, not previously accounted for	100.00
Amount entered in Cash Book and deposited	$1,100.00

Smith has now been properly credited, but in a few days Jones will have to be credited, and in order to do so, some other customer's remittance will have to be appropriated, which will probably be a larger amount than $200.00. If the cashier keeps up this process, keeps a very careful record of his actions and the customers' accounts involved and, at the same time, the abstractions are from currency collections, the embezzlement may gradually run up into a considerable amount. If spread out thin, and thus extended over a long period of time, this type of fraud is very difficult to detect and is generally uncovered by accident. If, however, the cashier begins to hold out checks, a very probable procedure after his manipulations of currency collections reaches a certain point in volume, his practices can readily be detected by checking the items on his bank deposit slip with the items on his cash book. Checks are individually listed and, as soon as checks are retained to cover either currency or other check shortages, discrepancies between the daily-deposit slips and the individual cash-book items will appear, although the totals will be the same in both places.

It is almost needless to say that this kind of fraud should be prevented rather than detected. The simplest preventive is to arrange that the proprietor or the manager of the business delegate a responsible individual to open all mail and to make an independent list of all checks and currency received. The total of these and the individual items should be checked daily against the bank deposit slips. At the same time the system should provide against the cashing of checks, change-making and payment of bills on petty expenses out of daily collections. A separate cash fund should be provided for those emergencies and needs.

4. Where a cashier receives and disburses funds and, at the same time, has access to or actually keeps the other books of account.

In a case of this kind, unless the manager of the business, or his assistant, receives and opens all mail, and lists therefrom, in detail, all checks and moneys received, the cashier-bookkeeper has almost an unlimited opportunity for peculation. If he retains currency from cash sales he can, through the journal, credit sales and charge some expense account and he can make the necessary charge to cost of sales for his credit to the inventory account reduced by the sale (if such an accounting procedure is in vogue). If he retains and cashes customer's checks he can credit the customer's account and charge either a regular expense account or discounts and allowances. He would probably not charge returned goods because someone might very probably discover that very few if any goods were returned.

Where a cashier (both receiving and paying) has full charge of all books, he can very easily enrich himself by creating fictitious liabilities (accounts payable), which he will liquidate by issuing checks to himself or to others that may be in collusion with him. This is especially easy if the cashier-bookkeeper himself, signs the checks. If checks are signed by the proprietor of the business and he requires the invoice before signing, it is still possible, unless purchases are very light, to submit a bill, already paid, a second time.

From the above discussion and few illustrations, it is readily apparent that the peculations of cashiers may take many forms and that eternal vigilance is necessary at all times when cash accounts are audited.

Credit Frauds. We have seen, from the estimates previously quoted, that credit frauds are about twice the amount of embezzlements. As a rule an entirely different personnel is involved in credit frauds. Ordinarily, of course, that personnel is the management.

A credit fraud may be defined as a misrepresentation, either verbally or in writing, which is made with the object of securing credit either as a purchaser of merchandise or as a borrower of money. The losses ensuing from this type of fraud arise and are determinable from the insolvency or bankruptcy of the fraud perpetrators. The fraud expresses itself in false balance sheets and profit and loss statements sometimes combined with verbal or written statements uttered in further explanation. Quite a number of states, including Illinois, Michigan, Ohio, Tennessee, California, and New York, have passed penal statutes dealing with the subject of obtaining moneys or merchandise on the basis of fraudulent statements. Fraudulent intent must naturally be proved before punishment can be meted out to the violators. In this connection it is important to note also the new provisions amendatory to the National Bankruptcy Act which went into effect on August 27, 1926. These amendments now make it possible to oppose the discharge of a bankrupt if he has obtained money or goods on credit by means of false financial statements.

The dangers from credit frauds could be very materially minimized, if the commercial and rating agencies, and the banks would insist upon statements certified by reputable certified public accountants. In fact, if the Credit rating agencies would have a special designation for ratings based upon such independent audits, the

extension of credit would soon be largely influenced by such special ratings. In view of the fact that the great bulk of business is done on credit, one can readily realize how important it is for the public accountant to make his audit comprehensive and thorough, and to submit a certificate which discloses clearly the financial status of his client. If all business houses were carefully audited by reputable public accountants, the losses from credit risks would be enormously reduced.

Stock Frauds. The losses from stock frauds are a real menace to the nation because they touch the very heart of national prosperity—the savings of the people. It is quite true that almost all the states have passed so-called "blue-sky" laws which regulate the sale of securities to the public. Securities offered for sale in these states are quite generally classified as speculative and nonspeculative, and the prospective purchaser is, therefore, put on guard at least, as to the kind of securities he is purchasing. Although the losses from stock frauds have doubtless been considerably reduced because of the various state Securities Acts, they are nevertheless still so large that one may reasonably assume that serious weaknesses exist in the administration of the laws. In some cases, due probably to the newness of this type of state control and to rather inefficient help, the administration of the laws and the punitive measures seem to be weak. The laws seem to offer quite a number of loopholes of escape and the control of the corporations selling securities is inadequate after the securities have once been sold. Oftentimes public sales which alone, in the majority of cases, come under the purvey of the state securities commissions, are avoided by the practice of issuing stock to original subscribers who then sell the stock as individuals. To avoid this condition some states demand that all stock on securities issued to officers and to the management be deposited in escrow with the state securities commission.

Good business should not be discouraged from seeking investors when financial needs and safe expansion are to be met, nor should new businesses of merit be prevented from coming into successful existence. In fact, unless the state commissions are eminently fair and quite liberal in their permits for new financing under the legal safeguards, a great deal of unjust and improper discrimination might result. Given a certain basis of safety upon which to build, no business that can clearly demonstrate the value of its product or service should be denied the right to expand or to come into industrial existence. However, when once registered with the state and licensed to sell its securities every business thus privileged should be subjected to the most careful and constant scrutiny of the state, at least, in so far as the rights and financial equities of the investors are concerned. The state might very advantageously require a quarterly audit by disinterested certified public accountants to be submitted to the securities commission in order that the investors' interests might be fully shown and safeguarded. It is not the prospects of the concern, at the time the license to sell securities is granted that determine whether the securities should have been sold, but rather the earnings themselves which follow the financing. The sale of securities by mail should also be extensively curtailed.

The public accountant, as a public servant, should concern himself with preventive measures to curtail the evil of stock frauds, and these measures should be directed primarily in the direction of insuring more effective accounting records, correct financial statements, and a co-operation with bankers, brokers, and state authorities. If, for example, all stock and bond brokers were put under state examination, like the banks, and their affairs were periodically reviewed through independent audits, considerable progress would be made in raising the business standards and practices of these financing agencies.

Since we have recognized that state supervision of securities sales is necessary, we might just as well make it thoroughly effective because to safeguard the public investor is just as important as the protection now extended to the national or state bank depositor.

Test Yourself on Essential Points

1. Outline the various forms of fraud that may be practiced by a cashier to misappropriate the cash funds of a business.
2. What steps should be taken to prevent such frauds?
3. Can you see any difference between a case of theft of cash and a case of fraud?
4. What is a credit fraud?
5. How can the dangers from credit frauds be minimized?
6. What are stock frauds and what preventive measures to curtail the evil of stock frauds may be followed.
7. What should be the attitude of the auditor when there is the first indication of fraud having been committed?

Chapter XLII

INVESTIGATIONS (Cont'd)

Reorganizations and New Financing

Incorporating from tax viewpoint—Consideration of changes in business organization—Types of reorganization—Refinancing—Examinations in connection with "blue-sky" law requirements—Types of securities—Procedure and legal requirements in Illinois—Miscellaneous special investigations—Purchase or sale of a business—Valuation of capital stock—System installation.

Very often, the public accountant is called in by business men to advise them as to the best form of business structure under certain conditions of business operations. This problem has many angles, and is by no means entirely a legal matter. There are other considerations deserving attention outside of the factor of legal responsibility. For example, there is the question of Federal income tax. The writer remembers distinctly a case when a partnership was dissolved at the close of the year 1917 and became a corporation in 1918. The result of this misstep cost the business more than $9,000.00 additional in income tax for the year 1918 alone. The same question merits consideration to-day. For the year 1926, corporation income taxes are at the rate of 13½ per cent, whereas taxes on individuals are at the following rates for normal tax:

1½ per cent on the first $4,000.00 in excess of credits provided by law.

3 per cent on the next $4,000.00.

5 per cent upon the remainder of the net income.

Incorporating from Tax Viewpoint. Assume a partnership of two, making $10,000.00 in profits distributable equally to the two partners. Would it pay the partners to incorporate their business? Would it pay at $30,000.00 net income?

Ten thousand dollars net income distributable to the

partners would give each $5,000.00; a credit of $1,500.00 would be allowed each, if they were single, leaving taxable income of $3,500.00 for each. The tax would be $52.50 for each, or a total of $105.00 for the two. Corporate net income would be subjected to a tax of 13½ per cent of $8,000.00 ($10,000.00) minus $2,000.00, exemption, because total net income is less than $25,000.00, or $1,080.00.

If the net income of the business were $30,000.00 ($15,000.00 to each partner), the combined tax of the two partners would be (if single) $1,030.00, without considering any possible earned income allowance. As a corporation, the business would pay a tax of $4,050.00. If the business' net income were $100,000.00, and it were a partnership, the partners would pay a total of $10,370.00 in taxes; as a corporation, the tax would be $13,500.00. In fact, not until the net income would be in excess of $140,000.00, would it pay to incorporate, from a purely tax standpoint, and even then it should be borne in mind that when a corporation pays large dividends, which it might in the case of a close corporation following a partnership, the recipients of the dividends would pay a surtax on individual amounts received in excess of $10,000.00.

Consideration of Changes in Business Organization. These details have been injected in order to show how careful the accountant must be in recommending changes in business organizations. In many instances it might be found that the advantages of certain legal immunities gained by incorporation would be far outweighed by the higher cost of corporate existence, of which Federal taxation is only one. On the other hand, where a business may be owned by many individuals, widely scattered, the costs of corporate existence are thoroughly justified. No other form of business organization is conceivable or feasible. Where financing on a large scale is necessary, it would be manifestly impossible to think of any other

than the corporate form of business organization. But, generally speaking, there has probably been too great a tendency toward incorporation on the part of small and medium sized businesses of purely local significance. Smaller concerns could probably be more effectively administered under a condition of concentrated investment and individual responsibility.

Types of Reorganizations. Usually, business reorganizations are of two types, namely:

1. Reorganizations of a single business in which the form is changed.
2. Reorganizations which result in the combination or merger of a number of concerns of allied objectives.

The latter type of reorganization we have already discussed elsewhere. The former type ordinarily, expresses itself in the change from individual proprietorship or partnership to the corporate form, generally with the idea of increasing business through the use of funds solicited from the general public. Again some of these reorganizations occur for the purpose of establishing present values of capital investment without admitting the general public. Whatever the object may be, the auditor is generally called upon to determine or to advise upon the following things:

1. The individuals' or partners' equities in the old business.
2. The amount by which the old equities should be increased because of present values of tangible properties, and because of the goodwill (if any) at present inherent in the business.
3. The total amount of capitalization to be provided for in the succeeding corporation and the class or classes of capital stock to be authorized and issued.
4. The amount of capital stock to be issued to the proprietors or partners of the old business on the basis of the revaluation indicated.
5. How the old proprietors are to retain control of the new corporate organization.

6. Closing the books of the old business and opening the books of the new corporation.
7. Installing a system of accounts for the new business.
8. Preparing the necessary data for state authorities for incorporation, state taxes or licenses, and possibly in connection with the requirements of "Blue Sky" laws and the sale of securities.
9. Preparation of financial statements for banks or stock brokers to be used in connection with the sale of securities to prospective investors.

Refinancing. If no change in the legal form of the business is contemplated, the auditor generally finds his task comprehended in the statements and reports which give emphasis to the stability of the business or to its earning power. Thus, a corporation already in operation, seeking new capital, would naturally have to prove that its appeal for additional funds was justified by a fine record of past earnings, by present financial solidity, and by good future prospects which would necessitate an enlargement of the capital fund. An individual proprietorship or a partnership seeking to mortgage property would be in much the same position. One can readily realize the large responsibility shouldered by the auditor in such cases. He must give full credit to the meritorious features of the business and yet he must be extremely careful not to become an advocate for his client. He must not himself try to sell the public, and the public must not be deceived in any way by the picture he paints. In short, he must state all the salient facts in any particular case, both good and bad, and must put the burden of drawing conclusions upon the readers of his statements and reports. He need not, for example, extol the excellency of management, because he may be able to convey the same message by saying that the management for the past several years was in certain hands and that certain results were obtained—the results generally expressing themselves in increased profits, or a fine dividend record, or in some other way. The auditor must give impartial

testimony by properly marshalling the salient facts; the public or the readers must be the judges.

In refinancing audits or examinations, the auditor should be expected to review and comment on the following features of the business:

1. A brief history of the business since its inception, showing changes in management and policies if any.
2. The present personnel of management.
3. The presence or absence of proper accounting systems.
4. A record of annual profits and losses since the business started.
5. The dividend record and policy since the inception of the business (if a corporation) or the amounts withdrawn by proprietors as profit distributions.
6. The policies with reference to enlarging the scope of the business and the amounts expended for these purposes.
7. The extent to which management and department heads are financially interested in the business.
8. An application of funds statement, for the entire history of business operations to show how working capital was increased or decreased, how property investment was increased, what dividends were paid and, finally, in connection therewith how injections of additional capital or increases in physical plant stimulated output or sales volume.
9. Significant comparisons between years or between natural periods of business operations.
10. Statements revealing present financial position and recent earnings, with a full disclosure of any contingent liabilities.
11. Statistics as to orders on hand, business rejected because of lack of working capital, and fields of expansion; present advertising and promotion policies, and contracts accepted both as to output and purchases.
12. Present banking connections and past relations with banks. Commercial ratings at present and in the past.

EXAMINATIONS IN CONNECTION WITH "BLUE SKY" LAW REQUIREMENTS

In most states capital stock cannot be sold by the issuing corporation or by brokers, until the securities commissions have officially licensed the act. Generally such sales are limited to a certain number of shares, and periodic statements are required showing the disposition of the proceeds, the financial position, and the earnings.

Types of Securities. As a rule, the states recognize two kinds of securities, namely, "speculative" and "nonspeculative."

"Speculative" securities are those issued by corporations which have no record of earnings; therefore, generally, new enterprises or older corporations that cannot qualify under the "nonspeculative" group. This does not mean that all new corporations may be qualified by license to sell stock, nor that the privilege will be accorded to corporations with inadequate earnings. These corporations must prove their worth before the state securities commissions in other ways. Their business must be legitimate, they must prove that they will be reasonably successful, and they must indicate the uses to which the sought funds are to be put. In addition, they must have been properly incorporated; the stipulated amounts of stock must have been subscribed and paid for, and the values for which stock was issued to original subscribers must be substantiated by appraisal, audit, etc. Stock issued to officers for goodwill and other intangibles is generally required to be escrowed, thus preventing the sale of promoters' stock. Already established companies, with inadequate earnings, are quite generally refused licenses because if such concerns did not earn a sufficient return on their capital stock in the past, the prospects of future earnings on a larger capital are extremely meager.

"Nonspeculative" securities are those issued by corporations whose earnings indicate a certain fixed or larger

return over a period of years, this return being related to the class, or classes of securities issued and outstanding. In Illinois, for example, a corporation wishing to sell its securities under Class C designation (nonspeculative) must file statements showing sufficient earnings for a period of two years prior to the date of application. How sufficient these earnings are, depends upon the kind and extent of the new financing. But no matter what kind of security the new issue is, the earnings must suffice to yield a certain return on the sum of the new issue and the amount already outstanding of the same kind of security, plus the requisite return upon any other security, having a prior claim on earnings.

Procedure and Legal Requirements in Illinois. Let us take an extreme case in order to illustrate the procedure and the legal requirements in Illinois. Corporation A has outstanding the following securities:

5% First Mortgage Bonds	$500,000.00
Preferred Stock (7 per cent)	500,000.00
Common Stock	100,000.00

and it has just issued $400,000.00 of additional common stock which it wishes to sell to the public as a Class C security in Illinois. The law provides that the corporation must show average annual earnings during the last two years to equal—

1. 1½ times the interest charges on its interest-bearing securities;
2. 1½ times the preferred dividend rate on its preferred stock, and
3. 3 per cent on the common stock which is to be sold and on that already outstanding.

In other words, the average annual earnings of Corporation A for two years prior would have to be at least the total reflected by the following calculation:

7½%	on $500,000.00	(Bonds)	$ 37,500.00
10½%	on 500,000.00	(Pref. Stock)	52,500.00
3 %	on 500,000.00	(Old and New Common)	15,000.00
			$105,000.00

If, instead of issuing common stock it decided to issue $400,000.00 preferred stock, its earnings would have to be as follows:

7½%	on $500,000.00	(Bonds)	$ 37,500.00
10½%	on 900,000.00	(Preferred—Old and New)	94,500.00
			$132,000.00

But if, finally, it decided to increase the bonded issue, its earnings would only have to be 7½ per cent of $900,000.00 (old and new bonds) or $67,500.00. The priority of other securities in earnings over those issued must always receive consideration, but a security subordinate to that issued need not be considered as long as the subordinate security holders have agreed, as demonstrated by proper resolutions, etc., further to subordinate their position with reference to earnings or proprietary equities.

The Illinois Securities Act, which is quite similar to the laws in other states, thus provides a fairly effective check on undue expansion. In other words, past earnings must warrant expansion, and expansion is limited definitely by the profitableness of the business, that is, if securities are to be sold under a "nonspeculative" designation.

Before granting licenses to sell securities, corporations in Illinois must comply with certain requirements, most of which indicate the need for public accounting services; the certificates and reports of certified public accountants naturally receive a greater amount of recognition, as contrasted to statements prepared by noncertified accountants. The requirements are briefly as follows:

1. All essential information regarding the corporation, the classes of capital stock or securities to be offered for sale, information regarding incorporation, authorized capital stock and past changes therein, voting power of stock, dividend rates and nature of dividends, bonded indebtedness, if any.
2. Financial statements:
   (a) Latest balance sheet (not more than six months prior to date of application).
   (b) Balance sheet to show the effect of the new financing.
   (c) Profit and loss statement covering a period of not less than two years up to the date of the latest balance sheet.
   (d) Analysis of Surplus Account for the entire period of the profit and loss statement.
   (e) Various schedules covering Notes and Accounts Receivable, Inventories, Deferred Charges, Investments, Machinery and Equipment, Real Estate (Land and Buildings), Intangible Assets, Notes and Accounts Payable, Long-Term Indebtedness, Gross Sales, Cost of Sales, Operating Expenses, Depreciation, Other Income, Miscellaneous Expenses, Interest on Bonds, Notes, etc., and Contingent Liabilities.
3. Other details regarding officers, their past records, the amount of stock to be sold and the price, etc.

The Illinois law provides that the secretary of state may designate a certified public accountant to make an examination of the books and records of the applicant and shall fix his fee, the latter to be paid by the applicant. Here is a clear recognition of the value of audits made by certified public accountants. In most cases, the selection of a certified public accountant is left to the corporation seeking to sell its securities, and the statements are all prepared by the certified public accountant. An examination of the statements and detailed schedules, called for by the law, indicates clearly a comprehensive, thorough, and, of course, unbiased task for the auditor.

It should also be remembered that after a license has been granted to sell securities, the issuing corporation must file semiannual supplementary statements showing

the moneys received, the disposition of funds, balance sheet and income statements, etc. These too are generally prepared by the certified public accountant who presented the initial statements.

We have discussed thus far the requirements with reference largely to the nonspeculative type of security. The requirements are even more stringent with regard to speculative securities. But these larger requirements are imposed upon the issuer of the securities and not upon the accountant. The accountant's task is much the same, as before outlined, although of smaller compass, because of the newness of the issuer's business. The state of Illinois publishes a small manual covering instructions as to statements required under the Securities or Blue-Sky Act, and the forms called for are shown in detail.

MISCELLANEOUS SPECIAL INVESTIGATIONS

Purchase or Sale of a Business. The investigation to be made by the auditor when a business is to be sold or to be purchased, as the case may be, resembles very largely that which occurs when a business is reorganized and much the same considerations are controlling. Whether the accountant represents the buyer or the seller, he must disclose the facts in an unbiased manner. He is not a salesman. He must know the present value of that which is to be bought or sold and, if an appraisal is necessary, he should recommend it. He himself should be able to appraise intangibles like goodwill, an item which appears quite generally when a business is sold.

Valuation of Capital Stock. Requests are quite often made of auditors to determine the value of capital stock. Let us remember that in consolidations it is often the practice to purchase the capital stock of prospective subsidiaries. Then, again, quite often a controlling stockholder or group of stockholders in an individual business may want to sell their interests to other stockholders or

outsiders who want the business. Here again the auditor must be able, by means of his own and other appraisals, to arrive at a fair value of the capital stock. The agreements between buyer and seller are naturally controlling. Contracts may specify present value of stocks as the basis or they may mention "book value." In specifying "book value," it is assumed that the books of account correctly reflect the value of the stock, but if they do not, it may be assumed that "book value" represents correct book value and that needed corrections should first be made on the books.

We can hardly believe that sales of stock on the basis of "book value" should embrace the results of appraisals not on the books. It might be contended, however, by some, that certain assets not on the books specifically, like goodwill, are nevertheless reflected as existing because of the financial strength of the business or because of its book record of earnings. There is a chance here of falling into a serious error.

If a company is very strong financially, and has developed a goodwill, but yet has confined its distribution of profits to a stipulated annual dividend rate, it is proper to hold that the goodwill increment (excess profits over a normal return on capital) is already largely reflected and present in the surplus account, the latter naturally influencing the book value of the capital stock. If, on the other hand, excess earnings have not been permitted to accumulate, but have been distributed liberally, the owners of the business have already been largely paid for their goodwill. They can expect to receive, therefore, only for that measure of goodwill which represents the future excess earning power of the business; in other words, for the earning power which they are denying themselves but which may or may not accrue to the purchasers of their stock. Goodwill is so much a matter of management and personal power, that prospective excess earnings of a business shorn of that

management are more or less speculative. All these matters the auditor must weigh very carefully when valuing capital stock.

System Installations. The matter of making investigations and surveys for systems installations is not primarily an audit engagement, although an audit will quite frequently indicate the weaknesses which a new system of accounts is expected to eliminate.

The extent of an investigation for system installation is influenced by the kind of system that is wanted. One concern may want only its cash accounting systematized, another may call for a system of accounting throughout the entire business. The system needed by a retailer is entirely different from that required by a manufacturer, even though the accounting principles are largely the same in both cases. The systematizer—accountant—must, therefore, be able to adjust himself to these variables, and he must be thoroughly grounded in his information about accounting methods, accounting principles, accounting forms, and the uses of mechanical accounting devices. Without this information, and a fund of varied experience, establishing contacts with many different kinds of businesses, no accountant is justified in posing as a systematizer except in the most limited sense.

The systematizer must be able to interpret the operations of any and all factors of a business. He must be able to see whether all activities are properly correlated and, finally, he must draft the forms and suggest the means whereby all the operations of a business may be properly and analytically reflected in periodic statements. His task is one of great responsibility and, if his work is effective, he is a most valuable adjunct to business management.

Test Yourself on Essential Points

1. The Automatic Fountain Pen Company consists of a partnership of four active partners, and has made an average annual net profit of $145,000.00. Two of the managing partners believe

that it is advisable to incorporate. The counsel of a public accountant is sought. From the standpoint of present income taxes as well as other considerations, outline whether the public accountant should recommend changes in the organization.

2. State and explain the usual types of reorganization.

3. Outline the public accountant's responsibility to both his client and the public in the case of an investigation of a corporation, already in operation, seeking new capital.

4. In refinancing audits and examinations, outline the features of the business which the auditor should be expected to review.

5. How should the auditor proceed in an examination in connection with "blue-sky" law requirements?

6. An investigation is made to determine the value of capital stock of a holding company and its subsidiaries. What salient points should the public accountant consider?

7. How does a system investigation differ from other special examinations?

Chapter XLIII

THE AUDITOR'S REPORT—WHAT IT SHOULD COVER

Considering the client's viewpoint—Comments on results of operations—Balance sheet accounts—Application of Funds statement—Importance of knowlege of income tax laws—Exhibits and schedules—Balance sheet grouping—Profit and loss statement—Comparative balance sheets—Percentages and charts.

The Client's Viewpoint Considered. An auditor is not justified in assuming that the management of a company is fully familiar with the entire operating details revealed by the company's accounts, and that therefore it needs no detailed report of operations and financial position. The manager of an industry is generally so engrossed with executive duties that he finds little time to make a careful analysis of the accounts. It is for this reason that he engages the public accountant to audit the affairs of his company.

He expects the auditor to show him how and why the operating results reported in the books are correct. He wants to know the causes for increased costs, the reasons for larger or smaller profits, and just where the company stands financially. He is interested in knowing whether the profits were reinvested in fixed assets or whether they served to increase the company's working capital. And, finally, he is interested in knowing whether the accounting department, which he intrusted with the important function of reflecting truly, in the books, the results of operations and the financial position of the company, is doing its work efficiently.

Results of Operations. The two questions uppermost in the manager's mind at the end of the fiscal period are: How much profit has the company made? and, How were the profits made? The auditor should therefore

begin his report with the subject of greatest interest to the management, namely, the Results of Operations.

Under this caption he should indicate clearly the factors that led to enhanced profits; this can best be done by comparing the current year's operations with those of the prior year. If sales have increased, the auditor should show how much of the increase was due to larger volume and how much to higher prices obtained for the company's product.

The percentages of costs, gross profits, selling and administrative expenses, net profits from operations, interest, and surplus net profits to sales should all be clearly indicated and the changes reflected in detail in whatever subsidiary exhibits are deemed necessary. The text of the report should not be burdened with these details, but should outline in summary form the various changes that have occurred, accompanied by interpretive comments.

Balance Sheet Accounts. The nature of the balance sheet accounts should be briefly discussed with reference to their composition and the methods employed for their verification. The manager is naturally interested in knowing that the assets and liabilities have all been properly accounted for and that they have been correctly valued for balance sheet purposes.

Application of Funds Statement. An application of funds statement is of great value in indicating the sources from which funds were provided and their disposition. In the statement one may readily see whether the profits and other funds were utilized to increase the working capital or whether they were used for making additions to capital assets. The growth or decrease in working capital as compared to any prior date is also revealed. Without a knowledge of the amount of working capital available for future operations, no intelligent planning can be done.

Federal Income Tax Laws. The Federal Income Tax laws are open to so many interpretations and are sometimes so vague that their application to a given situation is often beset with numerous troublesome difficulties. The auditor must make a thorough study of these laws. Without full knowledge he cannot hope to interpret correctly the accounts of any business organization. The liability for the tax should ordinarily appear in the books, and the auditor must know that the liability has been correctly set up. Because of the complexity of Federal Income Tax legislation, the auditor should indicate clearly, in the text of his report, how the liability was ascertained; the company's manager is not supposed to be a tax expert.

Exhibits and Schedules

Balance Sheet Grouping. The exhibits, or schedules, in an auditor's report are as important as the text. The balance sheet indicates the financial position of a concern and the accumulated results of operation. It should be logically grouped, preferably in the order of current realization and liquidation. The management is not primarily interested in the fixed assets and liabilities. These are more or less unchanged by current conditions. But there is a decided value in knowing what assets are readily convertible into cash, what immediate liabilities must be paid, and how much is then available to provide for current expansion.

Current Asset Group. The group of accounts entitled "Current Assets" should represent only assets that are being constantly converted into cash. If we include thereunder, Cash, Notes Receivable, Accounts Receivable, and Inventories we are observing the idea of convertibility fully. Cash is used to pay liabilities which were probably largely incurred to provide inventories; inventories are converted into accounts receivable, and

these in turn are converted into cash. There is an uninterrupted process of conversion.

Prepaid Expense. Following the current assets, the prepaid expenses should be presented, since they are very closely related to inventories, representing outlays benefiting the operations of the subsequent period.

Investment. If the company under audit has invested its surplus funds in stocks or bonds of other companies, or in mortgages or real estate not used in the conduct of the business, these investments may be properly shown in the balance sheet in a group just preceding the fixed asset group.

Fixed Assets Group. The more or less fixed assets should appear next in the balance sheet. These accounts indicate the character of an industry's permanency just as the current assets and liabilities indicate its immediate strength.

Deferred Asset Group. The deferred charges should come last, since these in reality are not assets at all. Their value on the balance sheet is dependent upon the preceding groups of assets which establish the permanency of an organization. It is this very basis of permanency, insuring the continuation of operations, which gives value to the deferred items that are to be charged against future operations.

Liabilities. On the liability side of the balance sheet there should appear the current liabilities which also include the accrued accounts, followed by the fixed liabilities.

Net Worth. After all the assets and liabilities have been included on the balance sheet, the remainder, which is in reality the most important group of accounts, represents the net worth of the company or business. It is essential that the accounts indicating net worth be in one group and that the group total stand out clearly in one amount which, when added to the liabilities, will

balance the total assets. Net worth is not a liability. It represents the capital contributed and the accumulated results from operations. It must therefore be the excess of assets over liabilities, and it indicates the real financial strength or power of an organization.

It shows what the investors or the stockholders have accomplished by the use of their capital, and the present value of their contributions. It indicates the amount available as rewards for the risk of investment (dividends or profits) and the amount which ought to be retained in the business as a protection to their capital. Net Worth is such a distinct account that it should always be expressed on the balance sheet in this form.

The English balance sheet construction on the credit side suffers particularly because it fails in this essential, beginning as it does with capital stock and ending with the surplus, thus separating the two accounts which establish not only the net worth of the business but the value of the proprietary interests.

Profit and Loss Statement. The second exhibit in an auditor's report should be the profit and loss statement for the period reviewed. This should indicate:

Gross sales.
Deductions from sales.
Net sales.
Component elements of cost of sales and the total thereof.
Gross profit from operations.
Selling and administrative expenses.
Net profit from operations.
Additions for nonoperating income.
Deductions for nonoperating expenses.
Total net profits to be carried to surplus.

Unless the percentages to sales of these various operating factors and results have been indicated in the report, they should be shown in the profit and loss statement.

Schedules. Whenever necessary, the profit and loss statement should be supplemented by schedules of details of the cost of sales and the selling and administration

expenses. Wherever possible, the subsidiary exhibit for the cost of sales should be augmented by a comparison with prior year or years, so as to indicate clearly changes in unit costs or, if unit costs cannot be shown, changes in the various operating costs.

It is only through comparisons of this kind that changes in operations can be interpreted and traced intelligently. It may not always be possible for the auditor to offer the proper suggestions to remedy weaknesses revealed through such comparisons, but if he has shown where the defects are and what they are, he has given the management all the clues necessary for a thorough investigation. The changes in costs and expenses should, of course, be reflected by and agree with the comments in his report.

Comparative Balance Sheets. There should also be a comparison of balance sheets (in summary form). Through this comparison the changes in working capital indicated in the application of funds statement of the report will be substantiated, and in general the increase or decrease in financial strength will be revealed.

Percentages and Charts. Public accountants are coming to use, more and more, either percentages or charts to indicate the comparisons between operating factors or the relations existing between income and expense. Charts may be used advantageously when comparing results and operations over a long period of time, or in analyzing these in detail by months or shorter periods during a year. For example, monthly sales could be conveniently charted with monthly selling expenses, and production with production costs.

Such charts might in some instances appeal more strongly than a schedule prepared on a percentage basis, although the latter would reveal the same thing. The whole matter is really one of psychology. A practical business man may prefer percentages, the imaginative

mind prefers a picture or a chart. In making use of these, the auditor should be guided largely by the type of executive to whom he is reporting. No one, however, will deny that an audit unaccompanied by either is inadequate and unsatisfactory.

Ratios. Significant ratios in both the balance sheet and the profit and loss statement should be disclosed and discussed. The current ratios should be compared with those of previous periods. Significant ratios are the following:

1. Current Assets to Current Liabilities.
2. Current Assets to Fixed Assets.
3. Net Quick Assets to Net Worth.
4. Cash to Bank Loans.
5. Accounts Receivable to Accounts Payable.
6. Inventories to Current Assets.
7. Debt to Net Worth.
8. Returned Goods to Sales.
9. Cost of Sales to Net Sales.
10. Administration and Selling Expenses to Gross Profit.
11. Selling Expenses to Net Sales.
12. Average Inventories to Cost of Sales.
13. Average Accounts Receivable to Charge Sales.
14. Cost of Sales to Fixed Investment.
15. Working Capital to Sales and Profits.

Test Yourself on Essential Points

1. How should the client's viewpoint be brought out in an audit report?

2. The following excerpt was found in an auditor's report: The petty cash fund was counted and found to be short $0.31. Would you have mentioned the difference?

3. Point out clearly whether you think every audit should contain a reconciliation of the surplus account and a statement of application of funds received and applied, giving your reasons therefor.

4. Outline the grouping you would make of the balance sheet items.

5. What classification should be made of the items of income and expense in a profit and loss statement?

6. What are the advantages of comparative statements and percentages and charts in an audit report?

Chapter XLIV

WORKING PAPERS OF AN AUDIT

Arrangement of working papers—Engagement blank—Time and expense reports—Courtesy and diplomacy of auditor—Working facilities—Schedules in reconciliation with statements—Copious notes on important matters—Preparation of the report—Eliminating nonessential information—Future of profession.

The Working Papers

Arrangement of Working Papers. The proper disposition and arrangement of the auditor's working papers are matters which have engaged the minds of public accountants for some time. The working papers must be preserved intact and should be so arranged and indexed that any section of them can be made accessible. The small audit offers no difficulties and the following procedure is recommended:

1. Arrange all working sheets according to the accounts with which they deal.
2. Group all the working papers according to the arrangement and order of the accounts as they appear in the balance sheet and profit and loss statement or in the trial balance. Thus the papers covering the cash count and cash in bank would come first in the file. These would be followed by the schedules and papers referring to notes receivable, etc., through the balance sheet accounts. Under the profit and loss accounts the arrangement would provide first for the general schedules and second for the subsidiary schedules. For example, the cost of sales account section would first cover the general schedules, but under each general schedule should be found the information contained in the auditor's subsidiary statements or exhibits relating to the cost of sales.
3. Index all the papers on a sheet or sheets placed on top or in front of the entire set of working papers. The index should be arranged according to the accounts as indicated above, and the working papers should be numbered consecutively. The index should indicate the kind of information contained in each paper.
4. Every working paper or sheet should be initialed by the accountant who prepared it, so that responsibility for all

the work may be properly allocated. A summary of the work of each accountant might be conveniently placed below the index. This will be of aid in making assignments when the same accounts are again audited.

5. The papers, if not too voluminous, should all be fastened together, or placed in a folder or pouch, and filed away in alphabetical order. At the same time the file clerk should prepare a card indicating the date when the audit was started and when it was completed. This card may be placed in a tickler file (arranged by dates) and will serve to inform the auditor when the audit will come up again, thus aiding him in making the proper assignments to the members of his staff. If the card also indicates the senior in charge of the engagement and his assistants, it will be possible to assign the same force to the next audit.

The working papers on some engagements are so voluminous that they cannot be handled in a regular file. Whenever this is true, the papers should be placed in large cardboard boxes, arranged according to indexes, the latter to be placed in the regular files. The papers may well be arranged in logical groups with a separate index for each group. Index tabs should be used to indicate the various groups in the box, and the group prefix should be shown on each working paper so as to prevent misfiling.

Conduct of an Audit

Engagement Blank. After an engagement has been obtained by the auditor, he should prepare an engagement memorandum containing the following information:

1. Name of client.
2. Client's address.
3. Client's telephone number.
4. Work arranged for by Mr..... with Mr..... (of the client's office).
5. Report to be addressed to Mr..... (title).
6. Account to be charged to.....
7. Nature of business.
8. Nature of audit or examination.
9. When to start.

10. Estimate of time required.
11. Staff requirements.
12. Rates: Senior in charge.
    Juniors.
    Firm members.
13. Report expected.....(date).

The senior to take charge of an engagement should know of the work about a week before it is to start, so that he may get together any working papers (if the accounts were previously audited) and so that he may provide his assistants. He should bear with him a letter of introduction to the proper official in the client's office, and should impress upon his assistants that any matters to be taken up with the client are to be referred to him.

Time and Expense Reports. The auditor in charge of an engagement should provide himself with time reports on which to report the time of himself and assistants. These reports should indicate not only the hours devoted to the work each day, but the nature of the work as well. If the engagement is out of the city, he must also take with him a sufficient number of expense reports.

Courtesy and Diplomacy of Auditor. The auditor should at all times be polite and deferential. He should introduce his assistants properly and should request introductions for himself and assistants to the various officials and accountants with whom he and his staff will have relations. Diplomacy and tact are necessary to establish the proper attitude in the minds of the bookkeepers or accountants whose work is being audited. It is always wise to make the client's employes feel that their assistance is appreciated and that they know their business.

If there is something radically wrong with the system of accounting, the client himself rather than his office force should be informed thereof. The auditor should ask only such questions as are absolutely necessary. He should learn to dig in and to determine things for himself.

He should never jump at conclusions, but reserve his judgments until he has investigated every phase of a situation thoroughly. He must not get into that frame of mind whereby he thinks every error the work of a "crook" or an incompetent. He should be lenient, patient, and constructive in whatever advice he may offer.

Proper Place for Work. It is important that the auditor and his staff have a proper place for work, preferably in a room separated from the general office. This provided, the auditor should next familiarize himself and staff with the books of account, and immediately distribute the work. This will require the exercise of considerable judgment, for work should be divided according to the various special abilities of the assistants.

Making the Assignment. Some of the accountants may be adepts at cost and manufacturing problems; others may have a special knack for inventory verifications. Some may be expert in analysis and in the examination of vouchers; others may be especially rapid and accurate in verifying footings or checking postings. The auditor should, of course, give thought to these things even before he starts an audit, so that as little time as possible will be consumed in making the assignments.

Schedules Reconciled with Statements. All schedules prepared by the auditor and his assistants should agree in amounts with the figures he uses in his report and statements. Any differences between the accounts per books and the amounts indicated in the auditor's report should be reconciled and explained in the working papers. Before leaving the client's office, all the papers must be in order and no questions left unanswered. It is very embarrassing for an auditor, after he has said good-by, to come back and confess to his client that he has overlooked some matters or desires further information on others.

Copious Notes on Important Matters. During the course

of an audit, the senior in charge should not neglect to make copious, clear notes on any matters which deserve further scrutiny or which should receive mention in the report. If these notes are clear and all the working papers in order, it will be a fairly easy task to write the report and to prepare the exhibits.

Whenever possible, the report and the exhibits should be prepared at the client's office. It is often difficult to convince a client that some work must be done after the auditor leaves the engagement, and consequently he may object to passing the auditor's bill when the charge is in excess of the time actually put in at his office.

Preparation of the Report. The report and statements should always be prepared in rough form by the senior in charge of the work. He is familiar with the entire situation and is more competent to emphasize the essentials than a member of the auditing firm. A firm member should, of course, pass on the final form of the report and should advise with reference to diction. Many good seniors have resigned their positions because of unjust criticisms and rebukes from firm members having certain hobbies or pet phraseologies. The general policies of a firm with reference to report construction should assuredly be followed, but not to the point of excluding all individuality on the part of the senior.

Eliminating Nonessential Information. The report should be filled with essentials, and the client should not be told a great many things that he knew possibly years before the auditor began to practice. The client should receive credit for possessing a fair degree of intelligence, and his time should not be consumed with a host of elementary explanations that imply an ignorance of his own business. Again, if a client has engaged an auditor to investigate only a certain phase of his business, it is absurd to foist on him a report which discusses in addition many things on which no information is desired. There is no

need to be presumptious nor to endeavor to impress the client with the vast wisdom of the auditor.

The two most important things for any auditor to learn, whether he be a senior accountant or the member of a firm, is modesty and the conviction that no man has a patent on knowledge. If these two qualities are coupled with intelligence and ability, the high and dignified profession of public accounting will speedily receive wider recognition and bring honor to its votaries.

The Future of the Profession. It is highly encouraging to members of the profession that solid progress is being made throughout the United States in legislation looking toward the development and elevation of public accounting. Nearly all the states now have Certified Public Accountants laws, and although some of these are inadequate, pressure from without will in time raise all to a uniform standard. The great work of the American Institute of Accountants and the American Society of Certified Public Accountants along this line cannot be too strongly commended. Many states have already adopted the Institute examinations, and it is hoped that more will follow. These developments will, we hope and believe, very soon drive the charlatan from the profession and make it impossible for anyone to practice who does not possess a recognized certificate or who is not employed by a firm or individual possessing such a certificate. It is as foolhardy to permit an incompetent to audit books and give advice to business men as it is to employ a "quack" to heal our physical ills.

The leading universities and many good correspondence schools are also doing a great deal of commendable work in preparing men for the profession. It is to be hoped that the various national associations of accountants will aid these schools in the establishment of adequate curricula by supplying them with proper advice regarding tests and instruction. The schools themselves

can aid by offering better remuneration for accountancy instruction. The government too is emphasizing the importance of good accounting and is giving more and more recognition to the public accountant's services. These and many other facts and tendencies lead us to believe that those who are capable and willing to meet fully the demands of public accountancy will find opportunity for the development and application of their talents and energies in a profession which can be confidently expected to wield a profound influence over every phase of the commerce and government of the world.

Chapter XLV

MODEL AUDIT REPORT

Division of report—Text of report—Actual audit report illustrated.

Divisions of Report. An auditor's report is ordinarily composed of three main divisions:

1. Text of Report or Comments.
2. Certificate.
3. Financial Statements.

Text of Report. The text of the report is usually composed of the following:

Introduction or Presentation.
Comments on Results of Operations.
Comments on Balance-Sheet Items.
Comments on Changes in Financial Position during the Period.
General Comments on the Audit.
Conclusion.

The report may be supplemented by, or there may be included as part of, the text, the auditor's certificate certifying as to the financial position of the concern audited and to the operating results. This certificate may be qualified or unqualified, depending entirely upon the auditor's findings. Very often the client wishes to publish his audited balance sheet; he rarely publishes an audit report. In that case, it is customary for the auditor to subscribe his certificate on the balance sheet itself.

The text section of the report should contain a very clear and specific explanation of the results from operation, followed by a discussion of the balance-sheet accounts as these appear in the auditor's balance-sheet exhibit. To this may be added a paragraph outlining the scope of the audit, followed, if necessary, by comments on the client's system of accounts with recommendations and suggestions as to possible improvements therein. The following will probably illustrate clearly the essentials of a good audit report:

AUDIT REPORT

of

JOHNSON BROS. AND COMPANY

for the

YEAR ENDED

DECEMBER 31, 1924

BROWN, SMITH & COMPANY
Certified Public Accountants
Chicago, Illinois

BROWN, SMITH & COMPANY
CERTIFIED PUBLIC ACCOUNTANTS
1464 Commerce Building, Chicago

February 15, 1925

Johnson Bros. & Company
Chicago, Illinois

Gentlemen:

We have audited the books of account and records of your company for the year ended December 31, 1924, and submit herewith the following exhibits showing the results of operations for the year and the financial condition at December 31, 1924:

BALANCE SHEET AT DECEMBER 31, 1924.EXHIBIT I

STATEMENT OF INCOME, PROFIT, AND LOSS FOR THE YEAR ENDED DECEMBER 31, 1924.....EXHIBIT II

STATEMENT OF COST OF SALES FOR THE YEAR ENDED DECEMBER 31, 1924..EXHIBIT III

COMPARATIVE BALANCE SHEETS AT DECEMBER 31, 1923 and DECEMBER 31, 1924 .....EXHIBIT IV

COMPARATIVE STATEMENT OF COST OF SALES FOR THE TWO YEARS 1923 and 1924 .....EXHIBIT V

COMPARATIVE STATEMENT OF INCOME, PROFIT, AND LOSS FOR THE TWO YEARS 1923 and 1924.....EXHIBIT VI

STATEMENT OF APPLICATION OF FUNDS FOR THE YEAR ENDED DECEMBER 31, 1924 .....EXHIBIT VII

ANALYSIS OF SURPLUS ACCOUNT FOR THE YEAR 1924 .....EXHIBIT VIII

I—COMMENTS ON RESULTS OF OPERATIONS

The following is a comparison of operations, in summary form, for the years 1923 and 1924:

	Year 1923	Year 1924	Increase
Net Sales	$802,256.47	$945,313.60	$143,057.13
Deduct—Cost of Sales	578,393.50	684,062.75	105,669.25
Ratio to Net Sales	72.10%	72.36%	-
Gross Profit	$223,862.97	$261,250.85	$ 37,387.88
Ratio to Net Sales	27.90%	27.64%	-
Deduct—Operating Expense	110,957.07	102,384.36	(Decrease) 8,572.71
Net Operating Profit	$112,905.90	$158,866.49	$ 45,960.59
Ratio to Net Sales	14.07%	16.80%	-
Add—Nonoperating Income	8,842.39	10,258.48	1,416.09
	$121,748.29	$169,124.97	$ 47,376.68
Deduct: Interest Expense		1,931.97	1,931.97
	$121,748.29	$167,193.00	$ 45,444.71
Ratio to Net Sales	15.17%	17.68%	-

A number of important trends are revealed from an inspection of the above comparison of operations for the years 1923 and 1924.

INCREASE IN SALES AND COST OF SALES—

Although Sales increased 17.83 per cent, the Cost of Sales increased 18.27 per cent. There is nothing alarming in this situation because, as will be explained later, freight on sales was largely deducted from 1924 sales and not so in 1923, and, because the larger productive factors that were under your direct control indicate cost decreases. By referring to Exhibit V (Comparative Statement of Cost of Sales) you will note that the Direct Shop Labor decreased by $17,047.82 and the materials used decreased by $14,873.39.

The big increase in costs was in the item of Outside Erecting Labor ($39,816.51), due probably to less-effective supervision over this class of labor, and to somewhat higher labor rates combined with a considerable labor turnover. Manufacturing overhead items for 1924, with the exception of depreciation, show a total increase of $25,572.57 over 1923. Indirect labor contributed $6,719.32 to the total increase.

We have already recommended to your management that a close study of this expense factor be made, with the idea of possibly introducing a number of mechanical devices to reduce the amount of indirect labor. There was also a noticeable increase ($7,960.94) in repairs and maintenance of machinery and buildings. This increase we do not believe is entirely real because an inspection of the charges seemed to indicate that many of them were replacements rather than repairs. Your policy in this respect is, of course, conservative and is therefore quite commendable. However, if carried too far, such a policy will eventually interfere with the depreciation factor, and will result in extensive adjustments to plant account and depreciation reserves later on.

In past years, your charges for depreciation have been somewhat too heavy, and our recommendations that these charges be scaled down have been accepted.

DECREASE IN OPERATING EXPENSE—

The decrease of $8,572.71 in Operating Expense is deserving of some comment, because it represents the difference between a large decrease of $49,981.49 in Selling Expenses and a large increase of $41,408.78 in Administrative Expenses. However, these changes are again not real nor need they lead to any misgivings on the part of your management.

The decrease in Selling Expense is almost entirely accounted for by a decrease of $29,920.09 in Freight on Sales, and by a decrease of $17,339.80 in Automobile Expense. The decrease in the freight item is due to the fact that during the year 1924 the freight on outgoing work was largely deducted from sales direct, so that the net sales figure was correspondingly reduced. This fact also amends the statement formerly made in this report as to the percentage increase of net sales. Had some $30,000 for freight been deducted from sales in 1923 to arrive at net sales for that year, the sales increase of 1924 over 1923 would have been 22.41 per cent instead of 17.83 per cent as indicated by Exhibit VI. Thus, the true facts show that sales have increased by a very good ratio, and that costs have not increased in proportion (18.27 per cent).

The decrease in Automobile Expense ($17,339.80) was entirely due to the fact that your company gave up the practice, in 1924, of maintaining and repairing the cars owned by the officers even though these cars were used to a considerable extent in promoting sales.

As the amounts expended for personal use and for company use could not be accurately determined, it was deemed best to exclude all automobile expense arising from the use of privately owned cars. At the same time, however, the expense remains inherently in the Profit and Loss Account for 1924, because of salary adjustments to cover this charge and to meet other considerations.

The increase of $41,408.78 in administrative expenses is almost entirely accounted for by an increase of $33,500.00 in Officers Salaries and of $7,910.39 in Bad Debts. Prior to 1924, the officers drew only low nominal salaries, which in no way measured the value of their services to the business. It was for this reason that the company, during 1923 and previous years, paid for officers automobile expenses, as previously commented on. In 1924, each of the three controlling officers' salaries were set at $12,000 a year (total $36,000), and the Secretary's salary was fixed at $6,500; the latter's salary was included by us under "Officers Salaries" in 1924, but was not so included in the 1923 statement. In 1923 the Secretary's salary was merged with "Clerical Salaries" upon the request of your management.

The increase of $7,910.39 in Bad Debts charged off is due entirely to a business policy. Merchandise to the extent of $9,388.00 (the amount charged off in 1924), was furnished to certain officers of a large corporation which had done an extremely large volume of profitable business with your company.

Your management was under the impression that the customer corporation was to be charged, and so made its charge. It developed, however, that the corporation was not liable, and since the materials shipped were used up in an unprofitable venture on the part of the individual officers of the corporation, it was deemed good policy, because of continued and future profitable business from the corporation, to cancel the charge. In reality this charge to "Bad Debts" account should have been made to Miscellaneous Selling Expense.

OVERHEAD DUE TO IDLE CAPACITY

During the year 1924, your plant worked at about 60 per cent of normal capacity, and yet you absorbed into costs the entire factory overhead. Assuming that the amount of indirect labor and all overhead not arising directly from your investment in plant and machinery were necessary for actual production, your cost of sales is, nevertheless, too high because of the plant and equipment overhead applicable to idle capacity. We refer particularly to the items of Insurance, Taxes and Depreciation, amounting in total to $41,364.36. In reality your production should have been burdened with only 60 per cent of these items, or $24,818.62, and the balance ($16,545.74) should have been charged as Unearned Burden or as loss due to idle capacity.

Your final net profits under your plan of costing would, of course, not be affected, but you would have a better idea of your actual operating profits on the actual production. In other words, your gross profits would have appeared at approximately $277,796.59, and your net operating profits at approximately $175,412.23, the difference of $16,545.74 in either case being then accounted for as a nonoperating expense.

If your plant were equipped with a scientific cost system, you would absorb into production and into inventory values, only that factory overhead which is created through the actual use of plant and machinery, as indicated by a rate based upon normal operations, and your inventories would not then include any value increment for idle plant capacity. During some years, especially during periods of growing finished inventories these points may well merit your attention, because if inventories then would include idle capacity increments you would be denying yourself the privilege of their deductibility as business losses through the unearned burden account in your Federal tax return. Your present method of accounting, however, makes all your expenditures deductible for tax purposes, but does not reflect your true manufacturing profits and does not provide a safeguard against finished or process inventory valuation, when these inventories are very large, and are growing from year to year during periods of subnormal production, because in your inventories you include an overhead charge based upon the ratio of all actual overhead expenditures of the year to direct labor.

II—COMMENTS ON BALANCE SHEET

The items in the balance sheet are, in general, self-explanatory, but there are a few upon which we desire to comment specifically.

CUSTOMERS' ACCOUNTS

Customers' accounts are apparently in excellent condition. Before our audit was completed practically all open accounts as at December 31, 1924, had been paid. This liquidity of your accounts receivable, combined with the large amount of cash and U. S. Government bonds, leads us again to the suggestion that you reduce the amount of cash and securities to a sum which will represent your actual cash needs.

During the entire year of 1924, your cash account has not been below $100,000.00, and when decreased to about that amount, the decrease was occasioned by the payment of dividends.

AVERAGE WORKING CAPITAL

The average working capital during the year was in excess of $500,000.00, and certainly that amount is not needed to finance a gross volume of $945,000.00, or to meet an annual expense schedule of about $770,000.00, quite equally spread during all the months of the year. This is especially true in the face of cash collections on customers accounts in excess of $900,000.00, and the knowledge that some of the expenses referred to do not represent cash outlays. An average cash balance of about $75,000.00, in our opinion, would be more than ample to take care of your needs, and would permit you to distribute any present cash surplus and your Liberty bonds in dividends.

RATIO OF CURRENT ASSETS TO CURRENT LIABILITIES

Your ratio of Current Assets to Current Liabilities at December 31, 1924, was in excess of 19 to 1, and with cash and securities reduced to $75,000.00, would still have been in excess of 10 to 1. Your prompt collections, assuming a continuation of business as heretofore, would make it possible to maintain that ratio quite consistently throughout the year, even though you continued your policy of paying a 100 per cent cash dividend on your capital stock of $100,000.00.

During the year, the account with H. F. Johnson,

your president, was reduced from $165,000.00 to $90,000.00.

FEDERAL TAX CLAIM

You will note that the amount of the Federal Tax Claim has been increased from $2,149.92 to $6,318.19. This claim had previously been reduced to $2,149.92 by the application of a part of it as a claim for credit against 1920 taxes, but by reason of a technical ruling of the collector, this credit could not be applied. The unpaid tax for 1921 was paid in 1925, and the full amount of your claim, $6,318.19, will be refunded with interest. We are advised that this claim has been certified to at Washington, and the amount should be refunded to you in the near future.

ADDITIONS TO FIXED PROPERTIES

The additions to fixed properties include the $21,776.65 expended for new roofing. As this addition was made late in the year 1924, no depreciation was taken on it. Inasmuch as the new roof will not last as long as the buildings and will sometime require replacement, we believe this improvement should be carried in a separate account and depreciated over its expected life. The additions to machinery and equipment comprise a Lowe crane, power hammer, engines, and other items of a minor character.

ACCRUED TAXES

The liability for accrued real estate and personal property taxes payable in 1925, was based upon the amount paid in 1924.

RESERVE FOR LAND VALUE ADJUSTMENT

The $500 received from the Power district for the right to run electrical conduit through your property has been credited to the account called Reserve for Land-Value Adjustment, set up by us two years ago. There is no method by which to measure the damage or loss in value to your property by reason of these easement rights, and, therefore, this money as well as that previously received for the sewer tunnel rights is carried in the reserve account.

III—SCOPE OF AUDIT

We examined all purchase vouchers for the year and the additions to fixed properties. The pay-roll records

were verified from the canceled pay-roll checks and compared with the general ledger accounts for the months of January, April, August, October and December.

Cash receipts and disbursements were verified and footings tested. The banks certified to us directly the amount of cash on deposit with them at December 31, 1924, and we reconciled these certificates with the ledger accounts.

Accounts Receivable were aged and uncollectible accounts written off. The detail of these accounts agreed with the control account.

Inventories were taken by the management and priced at cost or market, whichever was lower.

We verified the extensions and footings and made an exhaustive test of the pricing from purchase invoices and available market reports.

Depreciation on properties was computed in accordance with previously accepted rates.

IV—CERTIFICATE

We hereby CERTIFY that in our opinion the balance sheet and profit and loss statement attached hereto correctly set forth the financial condition of the company at December 31, 1924, and the result of operation for the year 1924, respectively.

Yours very truly,

Brown, Smith & Company

BROWN, SMITH & COMPANY
Certified Public Accountants

JOHNSON BROS. AND COMPANY

EXHIBIT I

BALANCE SHEET

DECEMBER 31, 1924

ASSETS

CURRENT ASSETS:-				
Cash in Banks			$216,245.12	
U.S. Government Bonds:-				
Third Liberty Loan 4¼%	$ 37,000.00			
Fourth Liberty Loan 4¼%	35,000.00	$ 72,000.00		
Accrued Interest on Liberty Bonds		768.54	72,768.54	
Accounts Receivable:-				
Customers		$156,706.30		
H. F. Johnson		90,000.00		
Officers and Employes		4,541.57		
Federal Tax Claim Allowed		6,318.19	257,566.06	
Inventories:-				
Raw Materials		$ 10,866.15		
Work in Process		19,649.11	30,515.26	$ 577,094.98
PREPAID EXPENSE:-				
Unexpired Insurance			55.42	
Auto Licenses for 1925			312.00	
Capital Stock and Franchise Tax			671.50	1,038.92

FIXED ASSETS:- (At Cost)	Cost	Reserve for Depreciation	Net Value	
Land - Water St.	$ 58,753.51	$	$ 58,753.51	
Land - Cragen District	74,067.57		74,067.57	
Buildings - Water St. (Salvage Value)	2,116.54		2,116.54	
" - Cragen - Plant	247,881.42	52,792.66	195,088.76	
" - " - Office	52,725.19	3,046.64	49,678.55	
New Roof on Plant Buildings - Cragen 1924	21,776.65		21,776.65	
Machinery and Equipment	398,006.41	197,450.41	200,556.00	
Trucks	4,555.58	1,139.71	3,415.87	
Office Furniture and Fixtures	12,124.39	6,664.02	5,460.37	
Lunch Room Equipment	708.12	438.23	269.89	
	$872,715.38	$261,531.67	$611,183.71	611,183.71
INTANGIBLE ASSETS:-				
Patents			$ 1,000.00	
Goodwill*			200,000.00	201,000.00
TOTAL ASSETS				$1,390,317.61

LIABILITIES

CURRENT LIABILITIES:-			
Accounts Payable - Trade		$ 6,454.35	
Accrued Liabilities:-			
Wages and Salaries	$ 4,406.83		
Property Taxes	14,213.71		
Compensation Insurance	4,955.37	23,577.91	$ 30,032.26
RESERVE FOR LAND VALUE ADJUSTMENTS:			
Compensation for Easement Rights to Sanitary District of Chicago for Sewer and Electrical Conduit under property			11,666.92

NET WORTH

CAPITAL STOCK Authorized and Issued	$100,000.00	
SURPLUS (Exhibit VIII)	$1,248,618.43	1,348,618.43
TOTAL LIABILITIES AND NET WORTH		$1,390,317.61

JOHNSON BROS. AND COMPANY

EXHIBIT II

INCOME, PROFIT AND LOSS STATEMENT

FOR THE YEAR ENDING DECEMBER 31, 1924.

GROSS SALES	$948,674.84		
Less: Allowances on Sales	3,361.24		
NET SALES		$945,313.60	
Deduct: COST OF SALES (EXHIBIT III)		684,062.75	
GROSS PROFIT ON SALES			$261,250.85
Deduct: SELLING EXPENSES:-			
Salesmen's Salaries and Commissions		$ 3,177.33	
Freight on Sales		7,387.13	
Traveling Expense		1,587.39	
Advertising		948.75	
Entertaining		2,177.14	
Miscellaneous		82.50	
Maintenance of Automobiles		415.02	15,775.26
			$245,475.59
Deduct: ADMINISTRATIVE EXPENSES:-			
Executive Salaries		$ 42,500.00	
Clerical Salaries		17,749.06	
Capital Stock Taxes		1,343.00	
Stationery and Supplies		1,207.46	
Telephone, Telegrams and Postage		1,135.69	
Legal, Auditing and Appraising		2,892.63	
Electrical Repairs and Replacements		21.72	
Maintenance - Office Bldg. - Cragen District		272.87	
" - Bldg. - Water Street		101.74	
Maintenance - Lunch Room		2.40	
Fuel - Office Heating		1,387.20	
Insurance Vault Contents		9.34	
Donations		2,355.00	
Dues and Subscription Trade Ass'ns.		1,134.00	
Freight and Express - Misc.		15.27	
Pensions		1,767.00	
Traveling Expenses		264.70	
Maintenance - Office Furn. & Fixtures		100.83	
Bad Accounts		9,388.00	
Miscellaneous		1,102.35	
Depreciation:			
Bldgs. Cragen District	$ 784.48		
Lunch Room Equipment	141.40		
Office Furniture & Fixtures	920.23	1,846.11	
Collection Fees		12.73	86,609.10
NET OPERATING PROFIT			$158,866.49
Add: NON-OPERATING INCOME:-			
Interest - Notes Receivable	$ 589.29		
" - Bank Balances	2,262.30		
" - U.S. Liberty Loan Bonds	3,060.00	$ 5,911.59	
Rentals		2,322.00	
Discount on Purchases		1,551.08	
Bad Debts Recovered		75.00	
Net Gain on Sale of Capital Assets		393.81	
Miscellaneous		5.00	10,258.48
			$169,124.97
Deduct: NON-OPERATING EXPENSE:-			
Interest Expense		$ 1,931.97	1,931.97
NET PROFIT FOR YEAR ENDED December 31, 1924 (Carried to Exhibit VIII)			$167,193.00

JOHNSON BROS. AND COMPANY

EXHIBIT III

STATEMENT OF COST OF SALES

FOR THE YEAR ENDED DECEMBER 31, 1924.

INVENTORY WORK IN PROCESS Jan. 1, 1924			$ 55,663.85
Inventory Raw Material Jan. 1, 1924		$ 9,667.10	
Purchases	$285,082.47		
Freight on Material Purchased	677.48	285,759.95	
		$295,427.05	
Less: Inventory Raw Materials Dec. 31, 1924		10,866.15	
COST OF MATERIALS USED			284,560.90
DIRECT LABOR:			
Direct Labor - Shop		$122,527.51	
" " - Outside Erection		91,769.29	214,296.80
MANUFACTURING EXPENSES:-			
Indirect Labor		$ 51,396.37	
Insurance		9,209.79	
Taxes		14,525.71	
Water		394.75	
Coal and Coal Freight		2,174.21	
Fuel Oil and Fuel Oil Freight		17,678.97	
Gasoline and Oil		1,088.83	
Electric Current Purchased		3,868.90	
Gas		3,082.31	
Electrical Repairs		329.53	
Maint. of Bldgs. - Cragen Plant		4,386.41	
Maint. of Mach. and Equipment		11,020.81	
Small Tools Replacement		4,768.44	
Patterns		1,251.47	
Shop Expense - Miscellaneous		2,516.63	
Drafting Room Expense		80.30	
Freight and Express - Miscellaneous		136.20	
Maintenance of Trucks		418.06	
Truck Chauffeurs' Salaries		3,383.78	
Depreciation:-			
Buildings - Cragen Plant	$ 3,718.22		
Machinery and Equipment	12,799.06		
Motor Trucks	1,111.58	17,628.86	149,340.33
INVENTORY WORK IN PROCESS Dec. 31, 1924			$703,861.86
			19,649.11
TOTAL COST OF MANUFACTURING			$684,212.75
Less: Amount received for fire loss			150.00
NET COST OF MANUFACTURING (carried to Exhibit II)			$684,062.75

JOHNSON BROS. AND COMPANY

EXHIBIT IV

COMPARATIVE BALANCE SHEET

DECEMBER 31, 1923 AND DECEMBER 31, 1924

ASSETS	December 31 1923	December 31, 1924	Increase or * Decrease
CURRENT ASSETS:-			
Cash in Banks	$104,161.18	$216,245.12	$112,083.94
U.S. Government Bonds	72,000.00	72,000.00	
Accrued Interest	768.54	768.54	
Accounts Receivable - Customers	138,499.51	156,706.30	18,206.79
Accounts Receivable - Personal	171,545.24	94,541.57	* 77,003.67
Federal Tax Claim Allowed	2,149.92	6,318.19	4,168.27
Inventories	65,330.93	30,515.26	* 34,815.67
TOTAL CURRENT ASSETS	$554,455.32	$577,094.98	$ 22,639.66
PREPAID EXPENSES	$ 277.90	$ 1,038.92	$ 761.02
FIXED ASSETS:- (After Depreciation)			
Land - Water Street	$ 58,753.51	$ 58,753.51	
Land - Cragen District	74,067.57	74,067.57	
Buildings - Water St. (Salvage Value)	2,116.54	2,116.54	
Buildings - Cragen Plant	198,806.98	195,088.76	$* 3,718.22
Buildings - " Office	49,610.61	49,678.55	67.94
New Roof on Plant Bldgs. Cragen 1924		21,776.65	21,776.65
Machinery and Equipment	192,472.78	200,556.00	8,083.22
" " " for sale	11,360.48		* 11,360.48
Autos & Trucks	6,758.93	3,415.87	* 3,343.06
Office Furniture and Fixtures	4,049.22	4,927.58	878.36
Lunch Room Equipment	409.04	269.89	* 139.15
TOTAL FIXED ASSETS	$598,405.66	$610,650.92	$ 12,245.26
INTANGIBLE ASSETS:-			
Goodwill	$200,000.00	$200,000.00	
Patents	1,000.00	1,000.00	
TOTAL INTANGIBLE ASSETS	$201,000.00	$201,000.00	
TOTAL ASSETS	$1,354,138.88	$1,389,784.82	$ 35,645.94
LIABILITIES			
CURRENT LIABILITIES:-			
Accounts Payable - Trade	$ 10,872.84	$ 6,454.35	$* 4,418.49
Accrued Payroll	2,624.16	4,408.83	1,784.67
" Taxes	10,877.31	14,213.71	3,336.40
" Insurance	1,690.08	4,955.37	3,265.29
TOTAL LIABILITIES	$ 26,064.39	$ 30,032.26	$ 3,967.87
RESERVE - Land Value Adjustment	$ 11,166.92	$ 11,666.92	$ 500.00
NET WORTH			
CAPITAL STOCK	$ 100,000.00	$ 100,000.00	
SURPLUS	1,216,907.57	1,248,085.64	$ 31,178.07
TOTAL NET WORTH	$1,316,907.57	$1,348,085.64	$ 31,178.07
TOTAL LIABILITIES AND NET WORTH	$1,354,138.88	$1,389,784.82	$ 35,645.94

JOHNSON BROS. AND COMPANY

EXHIBIT V

COMPARATIVE STATEMENT OF COST OF SALES

FOR THE TWO YEARS ENDED DECEMBER 31, 1924.

	1923	1924	Increase or * Decrease
INVENTORY - WORK IN PROCESS Jan. 1st	$ 17,152.88	$ 55,663.83	$ 38,510.95
COST OF MATERIAL PUT IN PROCESS	299,434.29	284,560.90	* 14,873.39
DIRECT LABOR:-			
Direct Shop Labor	139,575.33	122,527.51	* 17,047.82
Outside Erecting Labor	51,952.78	91,769.29	39,816.51
MANUFACTURING EXPENSES:-			
Indirect Labor	44,677.05	51,396.37	6,719.32
Power, Light and Heat	25,503.24	28,287.97	2,784.73
Small Tools Expense	2,642.41	4,768.44	2,126.03
Shop and Drafting Room Expense	2,210.42	2,733.13	522.71
Maintenance of Machinery	6,659.86	11,350.34	4,690.48
" of Buildings	1,115.95	4,386.41	3,270.46
" of Trucks	3,482.92	3,801.84	318.92
Insurance	7,754.51	9,209.79	1,455.28
Taxes	10,841.07	14,525.71	3,684.64
Depreciation - Factory and Equipment	19,435.01	17,628.86	* 1,806.15
Patterns	1,619.61	1,251.47	* 368.14
	$634,057.33	$703,861.86	$69,804.53
Deduct: INVENTORY WORK IN PROCESS Dec. 31st	55,663.83	19,649.11	*36,014.72
TOTAL COST OF MANUFACTURING	$578,395.50	$684,212.75	$105,819.25
Deduct: Amount received for fire loss		150.00	150.00
COST OF SALES	$578,393.50	$684,062.75	$105,669.25

JOHNSON BROS. AND COMPANY

EXHIBIT VI

COMPARATIVE STATEMENT OF INCOME, PROFIT AND LOSS

FOR THE TWO YEARS ENDED DECEMBER 31, 1924.

	1923	1924	Increase or *Decrease
SALES	$802,256.47	$945,313.60	$143,057.13
Deduct: COST OF SALES	578,393.50	684,062.75	105,669.25
GROSS PROFIT ON SALES	$223,862.97	$261,250.85	$ 37,387.88
Deduct: SELLING EXPENSES:-			
Salesmen's Salaries and Commissions	$ 4,766.67	$ 3,177.33	$ * 1,589.34
Traveling and Entertaining	3,905.11	3,764.53	* 140.58
Freight on Sales	37,307.22	7,387.13	* 29,920.09
Advertising	1,821.08	948.75	* 872.33
Miscellaneous	201.85	82.50	* 119.35
Automobile Expense	17,754.82	415.02	* 17,339.80
Total Selling Expenses	$ 65,756.75	$ 15,775.26	$*49,981.49
Deduct: ADMINISTRATIVE EXPENSES:-			
Officers Salaries	$ 9,000.00	$ 42,500.00	$ 33,500.00
Clerical Salaries	21,401.42	17,749.06	* 3,652.36
Auditing, Appraising & Legal	1,514.52	2,892.63	1,378.11
Dues and Subscriptions	766.00	1,134.00	368.00
Capital Stock Taxes	1,334.00	1,343.00	9.00
Stationery and Office Supplies	1,582.12	1,207.46	* 374.66
Telephone, Telegraph and Postage	1,327.70	1,135.69	* 192.01
Collection Fees etc.	46.05	12.73	* 33.32
Traveling Expenses	348.85	264.70	* 84.15
Maintenance of Office Equipment	660.06	1,760.90	1,100.84
Depreciation Office Equipment	1,917.98	1,846.11	* 71.87
Pensions to former employees	1,775.50	1,767.00	* 8.50
Contributions	1,150.46	2,355.00	1,204.54
Bad Debts	1,477.61	9,388.00	7,910.39
Maintenance - Building Water St.		101.74	101.74
Miscellaneous	898.05	1,151.08	253.03
Total Administrative Expenses	$ 45,200.32	$ 86,609.10	$ 41,408.78
NET OPERATING PROFIT	$112,905.90	$158,866.49	$ 45,960.59
Add: NON-OPERATING INCOME:-			
Rentals and Claims	$ 995.00	$ 2,322.00	$ 1,327.00
Interest Earned	4,697.20	5,911.59	1,214.39
Discount on Purchases	1,759.77	1,551.08	* 208.69
Gains on Sale of Capital Assets	1,030.97	393.81	* 637.16
Miscellaneous	359.45	80.00	* 279.45
	$ 8,842.39	$ 10,255.48	$ 1,416.09
	$121,748.29	$169,124.97	$ 47,376.68
Deduct: NON-OPERATING EXPENSES:-			
Interest Expense		$ 1,931.97	$ 1,931.97
NET PROFIT	$121,748.29	$167,193.00	$ 45,444.71

JOHNSON BROS. AND COMPANY

STATEMENT OF APPLICATION OF FUNDS

FOR THE YEAR ENDED DECEMBER 31, 1924.

EXHIBIT VII

FUNDS PROVIDED:-		
Net Profit for the year		$167,193.00
Depreciation Currently provided for		19,474.97
Proceeds from Sale of Capital Assets	$ 2,767.55	
Loss: Gain included in Net Profit above	393.81	2,373.74
Proceeds from Sale of Automobiles		6,421.43
Machinery scrapped (see surplus adjustment)		10,278.42
Compensation for Conduit Rights (Sanitary District)		500.00
Income Tax Claim Increased (net)		6,100.24
Surplus Arising From Prepaid Capital Stock and Franchise Tax		671.50
		$213,013.30
FUNDS APPLIED:-		
Dividends Paid	$100,000.00	
Income Tax 1923	8,835.29	
Unpaid portion of 1918 income tax	20,336.56	
1923 Real and Personal Property Taxes in excess of accrual	3,336.40	
Machinery Scrapped (charged to Surplus)	10,278.42	
Additions to Machinery	21,407.21	
" " Cragen District Office Bldg.	852.42	
" " Office Furniture and Fixtures	2,274.71	
" " Lunch Room	2.25	
" " Trucks	4,480.58	
New Roof	21,776.65	$193,580.49
Increase in Working Capital (as shown below)		19,432.81
		$213,013.30

STATEMENT OF WORKING CAPITAL

	Dec. 31, 1923	Dec. 31, 1924	Increase or * Decrease
Current Assets and Prepaid Expenses:-			
Cash	$104,161.18	$216,245.12	$112,083.94
U.S. Government Bonds	72,000.00	72,000.00	
Accrued Interest	768.54	768.54	
Accounts Receivable	310,044.75	251,247.87	* 58,796.88
Federal Tax Claim	2,149.92	6,318.19	4,168.27
Inventories	65,330.93	30,515.26	* 34,815.67
Unexpired Insurance	105.90	55.42	* 50.48
Prepaid Auto Licenses	172.00	312.00	140.00
Prepaid Capital Stock and Franchise Tax		671.50	671.50
	$554,733.22	$576,133.90	$ 23,400.68
Deduct: Current Liabilities:-			
Accounts Payable - Trade	$ 10,872.84	$ 6,454.35	* $ 4,418.49
Accrued Payroll	2,624.16	4,408.83	1,784.67
Accrued Taxes	10,877.31	14,213.71	3,336.40
Accrued Compensation Insurance	1,690.08	4,955.37	3,265.29
	$ 26,064.39	$ 30,032.26	$ 3,967.87
	$528,668.83	$548,101.64	$ 19,432.81

JOHNSON BROS. AND COMPANY

ANALYSIS OF SURPLUS

FOR YEAR ENDED DECEMBER 31, 1924

EXHIBIT VIII

SURPLUS BALANCE, JANUARY 1, 1924		$1,216,907.57
SURPLUS ADDITIONS:		
Adjustment for Federal Tax Claim allowed to Increase to Amount Refundable	$ 6,100.24	
Prepaid Capital Stock and Franchise Tax not recorded at Jan. 1, 1924	671.50	
Excessive Depreciation on Furniture and Fixtures	532.79	7,304.53
		$1,224,212.10
SURPLUS DEDUCTIONS:		
Unpaid portion of 1918 Income Tax	$ 20,336.56	
1923 Income Tax Paid	8,835.29	
Amount paid for 1923 real estate and personal property taxes in excess of amount accrued on books at Dec. 31, 1925	3,336.40	
Correction of 1923 Net Profit reporting incomes of $900.00 from sale of roll binders to O.M. & St. P. R.R. instead of a loss of $400.00 on this transaction	1,300.00	
Balance of Machinery and Equipment discarded in 1920 and no longer on hand	8,978.42	42,786.67
TOTAL SURPLUS ADJUSTED		$1,181,425.43
Deduct:		
DIVIDEND PAID:		
Dividend No. 89	$ 60,000.00	
Dividend No. 90	40,000.00	100,000.00
		$1,081,425.43
Add:		
NET PROFITS FOR YEAR 1924 (from Exhibit II)		167,193.00
SURPLUS, December 31, 1924 (to Exhibit I)		$1,248,618.43

INDEX

(Numbers Refer to Pages)

ACCOUNTANT'S ADVICE
On investing surplus cash, 14
On method of handling cash, 13, 14

ACCOUNTANT'S SOCIETIES
An aid to the profession, 395

ACCOUNTING
For sale of lots, 70

ACCOUNTING PROCEDURE
Illustrated, for timber companies, 296-298
For splitting dividends in timber companies, 296

ACCOUNTING RECORDS
Of life insurance companies, 285

ACCOUNTING SYSTEMS
For brokers, 273
For municipalities, 330, 331

ACCOUNTS PAYABLE
Audit, 112
Classified on balance sheet, 112
Purpose of analysis of, 112

ACCOUNTS PAYABLE LEDGER
Audit of, 112

ACCOUNTS RECEIVABLE
Agreement with controlling account, 20
Circularization of, 20
Compared with sales, 22, 23
How to schedule, 20
Proved through sales records, 22

ACCRUAL BASIS
Origin of, 117

ACCRUED ACCOUNTS
Sundry, 122

ACCRUED EXPENSES
Auditor's adjustment for, 207

ACCRUED INTEREST
Cases, verifying, 119, 120
Nature of, 118
Recorded monthly, 118, 119
Verified by auditor, 120

ACCRUED INTEREST RECEIVABLE
Computed by auditor, 25
Current asset, 25

ACCRUED LIABILITIES
Illustrations of, 118
Recognition of, 117

ACCRUED SALARIES
Verification of, 120

ACCRUED TAXES
How determined, 121

ACCRUED WAGES
How calculated, 120
How recorded in voucher system, 120
Set up by auditor, 120

ACTUARIAL SCIENCE
Used by the auditor, 98

ADDITIONS
Entered at cost, 71, 72

ADDITIONS AND BETTERMENTS
Examination of, 71

ADJUSTMENTS
For Discounts, illustrated, 59, 60
For Prepaid rents, 61, 62
For Prepaid taxes, 61
For Shrinkage in inventories, 34

ADMINISTRATIVE EXPENSE
Tested from vouchers, 213

ADVERTISING
Examination of expenditures for, 320
Current newspaper and magazine, 104
Deferred, 103
Income for electric railways, 254
Income for publishers, 294
In the automobile business, 320
Source of income for telephone companies, 257

ADVERTISING EXPENSE
Nature of, 212
When deferred, 212, 213

AMERICAN INSTITUTE OF ACCOUNTANTS
Quotation from bulletin of, 361

AMORTIZATION
Basis of, for patents, 86
Of bond discount illustrated, 97, 98
Of deferred advertising, 104
Of intangible assets, 89
Of leaseholds, 88
Of organization expense, 100
Of patents, 85

ANALYSIS
Detailed procedure for, 220-227
Of accounts, main purpose of, 227, 228
Of balance-sheet accounts, 220-227
Of income accounts, 190
Of inventory records, 191
Of profit and loss accounts, 220-227
Of selling expenses, 211

ANALYSIS OF ACCOUNTS
Outline of, 220

ANALYSIS OF SURPLUS
Of life insurance companies, 289

ANNUITY METHOD
For writing off buildings, 73
Of depreciation, 131

APPLICATION OF FUNDS STATEMENT
In auditor's report, 384
Purpose of, 111

APPRAISAL COMPANIES
Contributions of, in the valuation of machinery, 76, 77

APPRAISAL OF PROPERTY
Reasonable and authoritative, 82

APPRAISALS
To determine adequacy of insurance, 83

APPRECIATION
Of land values, 69

ARCHITECTS
Audit of books for, 313, 314

ASSETS
Intangible, 85
Values estimated, 107

AUDIT
An aid to management, 2, 3
Conduct of, 391-396
Constructive, 3
For defalcations, 198
Limitations of an, 2
Mechanical features of, 229
Miscellaneous, 332-340
Of accounts-payable ledger, 112
Of automobile manufacturers, 318, 319
Of balance-sheet accounts, 7-15
Of bank, 263-266
Of bond and stock brokers, 270
Of branch accounts, 302-304
Of business brokers, 282
Of camp pay rolls in timber companies, 299
Of cash in bank, 7, 8
Of charitable institutions, 343, 344
Of club accounts, 343
Of club and hotel accounts, 341
Of colleges and universities, 336-340
Of financial institutions, 262
Of fire insurance companies, 289
Of insurance companies, 284
Of mines, 301
Of municipal accounts, 323
Of oil mills, 315
Of premiums, in life insurance companies, 286
Of professional men's books, 311
Of proprietary and fund accounts, 323, 324
Of publishers' books, 291
Of sales accounts, 194, 195
Of special business types, 247-322
Of state banks, 266, 267
Of textile mills, 317, 318
Of timber companies, 295
Of trust companies, 269, 270
Of trustees' and executors' accounts, 331-336
Proper place for, 393
Value of an, 2, 3
Working papers of, 390

AUDIT ASSIGNMENT
How made, 393

AUDITING
Main purpose, 1

AUDITING PROFESSION
Aided by educational institutions, 395, 396
Aided by organizations, 395
The future of, 395

AUDIT OF ASSETS
Values estimated in, 107

AUDITOR
Aided by actuary, 287
Constructive suggestions on operations, 5
Courtesy and diplomacy of, 392
Qualifications of an, 1-2

AUDITOR'S ADVICE
On a new system, 198

AUDITOR'S ANALYSIS
Extent of, 220

AUDITOR'S CERTIFICATE
Limited for examination of securities, 64
Mentions secret reserves, 140
Qualified, 100
Qualified in balance-sheet audits, 4

AUDITOR'S DUTY
A partnership dissolution by law, 357, 358
In taking inventories, 35

AUDITOR'S EXAMINATION
Of partnership agreement, 163

AUDITOR'S LIABILITY
For secret reserves, 140
Limited, 6

AUDITOR'S NOTES
On important matters, 393, 394

AUDITOR'S RECOMMENDATIONS
For annuity method, 73
For handling cash in building and loan associations, 278
On accounting for business brokers, 282, 283
On insurance, 57
On investment of sinking fund, 66

AUDITOR'S REPORT
Content of, 383-389
Elimination of nonessential information, 394
Of exhibits and schedules, 385
On balance-sheet accounts, 384
On results of operations, 383, 384
Preparation of, 394
To give constructive report, 203
To show application of fund statement, 384

AUDITOR'S RESPONSIBILITY
Examination of trustees' and executors' accounts, 334
For canceled notes, 109
For departmental efficiency in branches, 304
For depreciation, 126
For dividend declarations, 180, 181, 182
For excessive depreciation, 132
For extraordinary expenses, 207
For inventories, 27
For liabilities, 107
For study of brokers' records, 273
For values of deferred charges, 100
In partnership dissolution, 353
In stock frauds, 368, 369
On balanced inventories, 38
On income tax matters, 385
Toward financial swindlers, 279

AUDIT REPORT
Consideration for client's viewpoint, 383
For consolidations, 246

AUDITS
Balance sheet, 4
Classification of, 4
Complete, 5
Continuous, 5
Special examinations, 6

AUTHORIZATIONS
For additions and betterments, 71
For returns and allowances, 215

AUTHORIZATION SYSTEM
Test of, 216

AUTOMOBILE INDUSTRY
Audit, 318, 319

BAD ACCOUNTS
Nature of, 218
When to write off, 21

BALANCED INVENTORIES
Meaning of, 38

BALANCE SHEET
Comparative, 111
Contingent liabilities in, 184, 185

BALANCE-SHEET ACCOUNTS
Audit, 7-15
Discussion of, in auditor's report, 384

BALANCE-SHEET AUDIT
Limitations, 4
Requirements, 4
Scope, 4

BALANCE-SHEET CERTIFICATE
Mention of excessive depreciation in, 132

BALANCE-SHEET CLASSIFICATION
In auditor's report, 385, 386

BANK AUDIT
Procedure for, 263-266

BANK RECONCILIATION STATEMENT
Form for, 9

BASIS OF ACCOUNTING
Accrual, 117

"BLUE SKY" LAWS
Limitations of, 170
Requirements, 375

BOND AND STOCK BROKERS
Audit, 270

BOND DISCOUNT
An additional interest charge, 97
How to write off, 96

BOND RETIREMENT
Illustrated, 150, 151
Through annuity principle, 150

BONDS
Registered, 63, 64, 144, 145
Retirement of, 145
Secured by mortgage, 142, 143
Two kinds of, 143, 144
Verified through interest coupons, 144

BOOK SURPLUS
Distinguished from actual surplus, 168

BRANCH ACCOUNTS
Audit, 302-304

BUILDING ACCOUNT
Examination of, 71
Schedules for analyzing, 72

BUILDING AND LOAN ASSOCIATIONS
Audit of, 275
Cash accounting for, 277, 278
Income of, 275
Segregation of profits by series, 277

BUILDINGS
Classified, 71
On leased premises, 73

BUSINESS BROKERS
Activities of, 282
Audit of, 282
Income of, 282
Rules of, 283

BUSINESS MEN'S ATTITUDE
On valuation of inventories, 33

BUSINESS ORGANIZATION
Consideration of changes in, 371, 372

CANCELED CHECKS
Examination of, 10

CAPITAL
Of a corporation, 164
Of partners, 163, 164

CAPITAL INVESTMENT
Recoverable, 79

CAPITAL STOCK
How verified, 165
In balance sheet, 165
No-par value, 169
Par value, 170
Valuation of, in reorganization, 379, 380

CAPITAL STOCK ACCOUNT
Not a liability, 161

CASH ACCOUNT
How to verify, 8, 9

CASH ACCOUNTING
For building and loan associations, 277, 278

CASH AUDIT
Procedure, 13, 14

CASH BALANCE
Maintained at normal, 14

CASH DEPOSITS
On automobile order, 318

CASH IN BANK
Audit, 7, 8

CASH RECEIPTS
Listed and classified, 12
Partly deposited, 11

CASH SALES
Possibility of inflation, 191
Procedure for, in department stores, 305, 306

CASH SLIPS
Evidence of cash sales, 191

CASH TURNOVER
How determined, 14

CATALOG INVENTORY ACCOUNT
Entries in, 213

CERTIFICATE
Banker's, for notes receivable discounted, 186
Banker's, on bank balance, 9
Beneficiaries' for guarantees, 186
For accounts payable, from creditor, 112
For inventories, 27
For notes held by others, 18
For pay rolls, 209
From broker on notes, 110
Of broker, for stocks purchased, 64

CERTIFIED PUBLIC ACCOUNTANT'S LAWS
An aid to developing the profession, 395

CHARITABLE INSTITUTIONS
Special problems in the audit of, 343, 344

CHECKING POSTINGS
In various ledgers, 230

CIRCULATION REVENUE
How to test, 294, 295

CLAIMS
Against railroads and express companies, 25
Verification of, 25
CLASSIFICATION OF ACCOUNTS
By Interstate Commerce Commission, 248
CLIENT'S VIEWPOINT
To be considered in audit reports, 383
CLUB ACCOUNTS
How to audit, 343
CLUB AND HOTEL ACCOUNTS
How to audit, 341
COLLATERAL LOANS
Listed by auditor, 271
COLLEGES AND UNIVERSITIES
Special problems in the audit of, 336-340
COMMISSIONS
How to check on, 212
COMMISSIONS FOR SALE OF STOCK
A promotion expense, 101
COMMISSIONS, IN THE SALE OF CAPITAL STOCK
Deductions from capital, 102
COMMISSIONS ON SALE OF STOCK
Charged to surplus, 103
COMMISSIONS PAYABLE
Listed, 122
COMPARATIVE BALANCE SHEET
Purpose of, in auditor's report, 388
Valuable for client, 111
COMPLETE AUDITS
More valuable than partial audits, 5
Nature of, 5
CONFIRMATION REQUESTS
In audit of brokers' margin accounts, 272
CONSIGNMENT ACCOUNTS
Separate from accounts receivable, 24
CONSIGNMENTS
How to value, publishers', 292
CONSIGNMENT SALES
Differ from regular sales, 24
CONSOLIDATION
How effected, 236
Illustrated, 236-238
Through new corporation, 236
Methods of effective, 234
Purpose of, 243
CONSTRUCTION WORK
Expenditures, examined for, 71, 72
CONTINGENT LIABILITIES
In auditor's report, 184, 185
Three methods of showing, 184, 185
Unfilled contracts, 187
CONTINUOUS AUDITS
Advantages, 5
Aids to management, 5
Essential features, 5
Limited or complete, 5
CONTRACT ACCOUNTING
General procedure, 308, 309
CONTRACT LEDGER
Entries in, 309
For departments of municipalities, 326
CONTRACTORS
Audit of contractors' books, 308
CONTRACTS
Unfilled, 186, 187
COPYRIGHTS
How to write off cost of, 88
Life of, 88
Valuation of, 293
CORPORATION
Advantages of, 164, 165
COST
Basis for selling prices, 34
COST OF PATENTS
Charged to manufacturing, 86
COST OR MARKET
Basis of valuing inventories, 33, 34
COST RECORDS
At cost values, 34
COUNTING CASH
In petty-cash fund, 12
COUNTING SYSTEM
Inspected by auditor, 203
COUPON BONDS
How verified, 144
CREDIT FRAUDS
Investigation of, 366, 367
CUSTOMER'S ACCOUNTS
Examination, for broker, 271
CUT-OFF INVENTORIES
Nature of, 33

DAMAGE SUITS
Determination of status by auditor, 254
DEFALCATIONS
By cashiers, illustrated, 363, 364
By branch managers, 303
By cashiers, 362-366
In building and loan associations, 275
DEFERRED ADVERTISING
Analysis of, 104
Indefinite deferred charge, 98
Prepaid expense, 103
DEFERRED CHARGES
Classification of, 96
Distinguished from prepaid expenses, 55, 56
Indefinite, 98
Nature of, 56
Of a fixed amount, 96
Position of, on the balance sheet, 96
DEFERRED CREDITS
Examination of, 157
On balance sheet, 157
DEFERRED EXPENSES
Auditor's adjustment for, 207
DEFERRED SELLING EXPENSE
An indefinite deferred charge, 98
In the balance sheet, 106
Proper apportionment of, 104, 105
Valued by banker, 106
DELIVERY EQUIPMENT
Depreciation, 81
Depreciation tables for, 80
DEMAND NOTES
Interest on, 110

DEMANDS OF CREDITORS
Special examinations for, 6
DEPARTMENT STORES
Cash sales in, 305, 306
C. O. D. sales in, 306
Distribution of general expenses, 307, 308
Internal audit, 305
Purchases, 306
Vouching expense, 306, 307
DEPOSITS ON CONTRACTS
Subject to refunds, 25
DEPRECIATION
Annuity method, 131
An operating expense, 73
Effect of excessive, 132, 133
Fixed percentage on diminishing-values method, 129
Fixed percentage on cost method, 129
In oil mills, 316, 317
Methods compared, 129, 130
Necessity for recognizing, 127, 128
Of electric railway property, 253
Of equipment in telephone companies, 259
Of fixed property, 81, 82
Of land, 69
Of telephone property, 257, 258
On additions to buildings, 72, 73
Reserve for, 126-129
Sinking-fund method, 131
To cover obsolescence, 131
DEPRECIATION OF EQUIPMENT
How to provide, in mines, 301
In timber companies, 299
DEPRECIATION OF GOOD WILL
Not allowed by the Government, 95
DEPRECIATION RESERVES
Providing adequate, 131, 132
DISCOUNTS
When included in prepaid interest, 58
DIVIDEND RATE
Limited by states in life insurance companies, 289
DIVIDENDS
Declaration of, 123
Distributed out of surplus reserves, 136
Legally justifiable, 99
Nature of, in timber companies, 296
On cumulative preferred stock, 176-180
On no-par value stock, 172-174
On various kinds of stock, 173
DIVIDENDS PAYABLE
Current liability, 123
Eliminated in consolidated balance sheet, 245
Entry for, 123
In minute book, 123
DOCTORS
Audit of books for, 312, 313
DRAWINGS AND PATTERNS
Careful inspection necessary, 80
Depreciation of, 80

EARNED SURPLUS
Available for dividends, 174
EDUCATIONAL INSTITUTIONS
Audit, 336-340
ELECTRIC LIGHT AND POWER COMPANIES
Production and revenue, 258
ELECTRIC RAILWAY ACCOUNTS
Main features in examination of, 252
ELECTRIC RAILWAY PROPERTY
Depreciation of, 253, 254
ELECTRIC ROADS
Classification of, 250
ELIMINATION
Of investment, in subsidiaries, 241
EMPLOYES' ACCOUNTS
Separate from other accounts receivable, 23
ENGAGEMENT BLANK
First requirement in audit, 391
Investigation on, 391, 392
EXAMINATION
Of canceled checks, 10
Of insurance policies, 73, 74
EXCHANGE CHARGES
Deducted by bank, 8
Monthly statement of, 8
EXCHANGE ON DRAFTS
Monthly statement of, 8
EXHIBITS AND SCHEDULES
Main items in, 385, 386
EXPENDITURES
Classification of, for universities, 337-339
EXPENSES
Administrative, 213
Advertising, 212, 213
Bad debts, 218, 219
Classification of, 204
Commissions, 211
Extraordinary, 204
Factory costs, 217, 218
Freight and express, 217
General, 213, 214
Interest on loans, 216, 217
Legal, 214
Organization, 100
Prepaid, 55
Salaries, 211
Selling, 211
EXPENSE ACCOUNTS
Audit, 198
EXPENSE AUDIT
Under voucher system, 198-200
Under nonvoucher system, 202
EXTRAORDINARY EXPENSES
Deductions from net profit, 206
Illustrated, 204-207
When charged against operations, 205

FACTORY COSTS
Verification of, 217, 218
FACTORY PAY ROLLS
Examination of, 209
FEDERAL INCOME TAX
Accrual of, 121
Deducted from net profit, 121

FEDERAL INCOME TAX LAWS
Auditor's knowledge of, necessary, 385
FEDERAL RESERVE BANKS
Audit, 263
FEDERAL RESERVE BOARD
Rules for checking inventories, 27-32
FINANCIAL INSTITUTIONS
Audit, 262
Engaged in illegitimate business, 278, 279
Illustrations of, 262
FINES
Income from, 276
FIRE INSURANCE COMPANIES
Audit, 289
Nature of premiums, 289
FIRE-LOSS ADJUSTMENTS
Based upon auditor's balance sheet, 346
Illustrated, 346
Special examinations for, 6
FIRE LOSSES
Determining inventory at date of fire, 348, 349
Special investigations for, 346
FIXED ASSETS
Deferred charges to operations, 78
Preparation of schedules for, 68
FIXED LIABILITIES
Illustrated, 141
Nature of, 141
FIXED PERCENTAGE ON COST METHOD
Of depreciation, 129
FIXED PERCENTAGE ON DIMINISHING-VALUES METHOD
Of depreciation, 129
FIXED PROPERTY
Profit from sale of, 82
FOOTING
Books that require, 229
FORM
For cash accounting, 278
FORMULA
For detecting sales inflation, 191
For diminishing-values method of depreciation, 130
For proving cash receipts and disbursements, 229, 230
For proving cost of sales, 196
For proving weights of production in oil mill, 316
For sinking-fund installments, 151, 152
For working capital in building and loan associations, 277
Method of proof for inventories, 32
FORMULA FOR SINKING-FUND INSTALLMENTS
Application illustrated, 152-155
FRANCHISES
Amortizing cost of, 88
Defined, 88
FRAUD AND DEFALCATION
Investigation for, 361, 362
Special examination for, 6
FREIGHT AND EXPRESS
Detection of overcharges, 217
FREIGHT REVENUE
Source of, 249
FUND ACCOUNTS
For municipalities, 323, 324
FUND LEDGER
For municipalities, 326, 327

GAS COMPANIES
Accounts, 259
GENERAL EXPENSES
Items included under, 213, 214
Liability for, 213, 214
Method of distributing in department stores, 307, 308
GENERAL LEDGER
Test for postings in, 232
GOODS IN PROCESS
Valuation illustrated, V, 43, 44
GOOD WILL
Based on excess profit-making power, 92, 93
Computations illustrated, 91, 92
Created by good management, 92
Defined, 90, 240
Depreciation of, 95
Factors to be considered in calculation, 92
How to determine value of, 90, 91
In case of mergers or consolidations, 94, 240
Reduction of, 241
When not determinable, 91
When placed on books, 90
GOVERNMENTAL CONTROL
Recent developments of, 247, 248
GROSS PROFIT
Unrealized, on installment sales, 157-159
GROSS PROFIT PERCENTAGES
In testing inventories, 347, 348
GROSS PROFIT TEST
Illustrated, 37
Of inventories, 27
GUARANTEES
Contingent liability, 186
GUEST REGISTRATION
Examination of, by auditor, 341, 342

HOLDING COMPANY
Assets of a, 238
For purposes of control, 238
Income of, 238
HYPOTHECATION
Of assets, 108
Disclosure of, 187, 188

ILLINOIS SECURITIES ACT
Application of, 377
IMPROVED REAL ESTATE LEDGER
At cost, 70
INCOME
Danger of inflation, 190
For hotels, 342, 343

From premiums, in life insurance companies, 286
From sale of scrap, 195
From securities, in investment companies, 280
Of building and loan associations, 275
Of business brokers, 282
Of holding company, 238
Of municipalities, 327, 328
Of publishers, 291
Of telephone companies, classified, 256
Of wholesalers and retailers, 195
Source of, in mining companies, 301
Verification of, for universities, 339, 340
INCOME ACCOUNTS
Audit, 190
Of manufacturers, 192
INCOME FROM ADVERTISING
For electric railways, 254
For telephone companies, 257
INCOME FROM INVESTMENTS
Examination of, 276
In building and loan associations, 276
INCOME FROM TAXATION
In municipalities, 327, 328
INCOME TAX LEGISLATION
Special examination for, 6
INCORPORATION
Advisability of, from tax viewpoint, 370, 371
INCUMBRANCES
Of municipalities, 325, 326
INDIVIDUAL PROPRIETOR
Capital of, 161-163
INDORSED CHECK
Inadequate proof of validity of payment, 11
INDORSEMENTS
Contingent liability for, 186
INFLATION OF SALES
Method of detecting, 190, 192
INITIATION FEES
Credited to reserve account, 277
In building and loan associations, 277
INSPECTION
Of cash sales, 197
Of charges to building account, 72
Of insurance policies, 58
Of pay rolls, 208
Of shipping records, 191
Of unfilled contracts, 187
Of unfilled sales orders, 194, 195
INSTALLMENT ACCOUNTS
How to verify, 24
Nature of, 24
INSTALLMENT SALES
Repossessed, IV, 24
Unrealized gross profit on, 157-159
INSURANCE
On buildings, 73, 74
On finished cars, 319
INSURANCE COMPANIES
Audit, 284
Life, 285
State regulation of, 284, 285
INSURANCE REGISTER
Important features of, 56, 57
INSURANCE RESERVES
How to test, 287
INTANGIBLE ASSETS
Defined, 85
Good will, 90
Illustrations of, 85
Where placed on balance sheet, 89
INTERCOMPANY ACCOUNTING
After consolidation, 243-245
INTERCOMPANY ELIMINATIONS
For sales and purchases, 244
INTEREST
On drafts discounted, 8
On sinking funds, 149
On unpaid liabilities, 216, 217
INTEREST EXPENSE ACCOUNT
How verified, 216
INTEREST ON LOANS
A financial expense, 216
Source of income for building and loan associations, 275
INTERESTS IN ROYALTIES
Special examinations for, 6
INTERNAL CHECK
An aid to the auditor, 210
In department stores, 305
INTERSTATE COMMERCE COMMISSION
Purpose of, 247
INTERURBAN LINES
Revenue of, 250
INVENTORIES
At cost, 50, 51
At market, 51, 52
At selling price, 52, 53
Auditor's responsibility for, 27
Bases of valuation for, 33, 34
By dealers in securities, 52
By the auditor, 35
Determination of, in case of fire, 348, 349
Fluctuations of, in balance sheet, 34
In process, 32
Income tax requirements, 40
Methods of valuation, illustrated, 41
Of automobile manufactures, 319, 320
Of contractors, 308
Of finished goods, 36, 37
Of goods in process, 36
Proved by quantities or values, 35
Valued without cost system, 45
Verified by formula, 32
Verified by governmental rules, 27, 32
INVENTORY SHRINKAGE
Temporary condition, 33
INVENTORY VALUATION
Consistency of, 49, 50
INVESTIGATION
For defalcation by cashiers, 362-366
For fire losses, 346, 351
For fraud and defalcation, 361
For partnership dissolution, 352-360
For reorganizations, 370-382
Of credit frauds, 366, 367
Of franchises, 88
Of loans, 108
INVESTMENT ACCOUNT
At cost, 63

Operations of, 279, 280
Reserve for profits in, 281
INVESTMENTS
In buildings, 71
In securities, 62
In subsidiary corporations, 64
Of sinking funds, 66
Of university funds, 340
On balance sheet, of investment companies, 281, 282
Valuation of, in investment companies, 281, 282
Verified, in life insurance companies, 287, 288
INVESTMENTS AT COST
For investment companies, 280
INVESTMENTS IN SECURITIES
Place of balance sheet, 62
INVESTMENTS OF LIFE INSURANCE COMPANIES
Nature of, 288

LAND
Depreciation of, 69
Taxes on, 68, 69
LAND ACCOUNT
Items to be charged to, 69
Of a land company, 70
Procedure for audit of, 68
LAND COMPANIES
Accounting for, 70
LAND VALUES
Appreciation of, 69
LANDS
Classification of, 68
LAWYERS
Audit of books for, 313
LEASEHOLDS
Purchase price of, to be amortized, 88
Recorded at cost, 88
Revalued when sold, 88
LEGAL BILLS
For period covered, 123
LEGAL EXPENSE
Analysis of, 214
LIABILITIES
Accrued, 117
Contingent, 184
Definite in amount, 107
Tests of, in life insurance companies, 288, 289
LIABILITY
For dividends, illustrated, 178-180
LIENS
Examination of, 155, 156
LIFE INSURANCE COMPANIES
Accounting records of, 285
Analysis of surplus of, 289
Income from premiums, 286
Nature of investments of, 288
Past-due accounts of, 287
Tests for liabilities of, 288, 289
Vouching payments of, 287
LITIGATION
Special examinations for, 6
LOCAL SERVICE TELEPHONE
Recorded in contract ledger, 256, 257

LOSSES
From accounts receivable, 134
LOT LEDGER
Entries cost, 70
What it contains, 70
LOT LEDGER ACCOUNT
Charges to, 70

MACHINES
Detail records for, 76
Obsolete, 79
MACHINERY
Depreciation of, 76
Life of, 76
MACHINERY ACCOUNT
How to analyze, 76
MACHINERY LEDGERS
Form of, 77
MACHINERY RECORDS
Tied up with general books, 76
MANAGERIAL CONTROL
Indexed by rate of cash turnover, 14
MANUFACTURERS' SALES
Auditor's check of, 193
How proved, 192, 193
MARGIN ACCOUNTS
Examination of, 273
MERGER
How effected, 234
Illustrated, 234
METHOD
Annuity, for depreciation, 131
Of detecting inflation of sales, 190-192
Of figuring depreciation, 128, 129
Percentage to sales, for bad accounts, 134, 135
Sinking fund for depreciation, 131
METHOD OF INVENTORYING
Not allowed by Government, 50
MINES
Audit, 301
MINORITY INTERESTS
In consolidated balance sheet, 243
MINORITY STOCKHOLDERS'
Share in deficit, 243
MINUTE BOOK
Auditors examination of, 123
Basis for verification of stock subscriptions, 25
Evidence of liabilities, 123
Examination for hypothecations, 187
Examination of, 188
MODEL AUDIT REPORT
Divisions of, 397
Illustrated, 397-406
Text of, 397
MONTHLY STATEMENT
Of exchange charges, 8
Of exchange on drafts, 8
Of interest on drafts, 8
MORTGAGES
Held as investments, 64
Of defunct corporation, 65
Properly recorded, 64
Two kinds of, 141, 142

MUNICIPAL ACCOUNTING
Inefficiency of, 323
MUNICIPAL ACCOUNTS
Audit, 323
MUNICIPALITIES
Source of income, 327, 328

NATIONAL BANKS
Audit, 263
NONSPECULATIVE SECURITIES
Nature of, 375, 376
NONVOUCHER SYSTEM
Expense audit under, 202
NO-PAR VALUE STOCK
Determination of book value, 171, 172
Dividends on, 172-174
Nature of, 170
On balance sheet, 170, 171
NOTE HOLDERS
Circularization of, 108, 109
NOTES PAYABLE
For loans, 108
For services, 111
How to list, 108
How to schedule, 107
On contracts, 110
To officers or employes, 108
When given, 107
NOTES PAYABLE REGISTERS
How used in an audit, 109
NOTES RECEIVABLE
Audit of missing, 18
Compared with open accounts, 16
How to list, 16
Of employes or officers, 17
Past due, listed, 18
Proved by circularization, 17
NOTES RECEIVABLE DISCOUNTED
A contingent liability, 186
Certified by bank, 196
In balance sheet, 19, 185, 186
Need for special account, 19

OBSOLESCENCE
Of machines, 79
Provided for in depreciation reserve, 131, 132, 206, 207
OFFICE FURNITURE AND FIXTURES
At nominal value, 80
Carried at operating value, 80
OFFICERS' ACCOUNTS
Separate from other accounts receivable, 23
To be discouraged, 23
OIL MILLS
Audit, 315
Depreciation in, 316, 317
How they operate, 315
ORGANIZATION EXPENSE
A deferred charge, 98, 99
Amortization, 100
Valued by the banker, 99, 100
When charged to operations, 99
ORGANIZATION EXPENSE ACCOUNT
How to analyze, 101

OUTLINE
Of analysis of accounts, illustrated, 220, 227
OVERINVESTMENT
In inventories, 39

PARTNERSHIP DISPUTES
Special examinations for, 6
PARTNERSHIP DISSOLUTION
By court order, 359
By law, 357, 358
By partners' agreement, 352
Illustrative problem and solution, 353-357
PATENT ACCOUNT
Charges analyzed, 87
PATENTS
Expense in protection of, 87
How to determine value of, 85, 86
How to write off, 85
Initial valuation of, 86
Legal expense in connection with, 87
Life of, 85
Purchased with good will, 86, 87
When included on the balance sheet, 86
When obsolete, 87
PAYMENTS
Vouching, in life insurance companies, 287
PAY-ROLL PADDING
How detected, 208, 209
PAY-ROLL PROCEDURE
To be investigated, 208
PAY ROLLS
How to check, 208-210
PERCENTAGE TO SALES METHOD
For losses from bad accounts, 134, 135
PERCENTAGES AND CHARTS
Used in auditor's report, 388, 389
PERPETUAL INVENTORY SYSTEM
Advantages of, 196
PHYSICAL INVENTORY
Of office employes, 208
POSTINGS
Sources of, 230
Traced to original source, 231
PREMIUMS
Nature of, in fire insurance companies, 289
PREMIUM ON BONDS
Amortization of, 160
PREMIUMS ON CAPITAL STOCK
In special surplus account, 136
Not a reserve, 136
PREMIUMS ON LOANS
How to verify, 276
Nature of, 276
PREMIUM ON SUBSIDIARY STOCK
In consolidations, 240
PREPAID COMMISSIONS
A deferred charge, 98
PREPAID EXPENSES
Distinguished from deferred charges, 55
Items included under, 55

Nature of, 55
On balance sheet, 55
PREPAID INSURANCE
How handled, 56
PREPAID INTEREST
When to be adjusted, 58
PREPAID RENTS
Adjustments for, 61, 62
PREPAID ROYALTIES
A deferred charge, 98
PREPAID TAXES
Properly apportioned, 61
PRODUCTION AND CONSUMPTION
Of gas companies, 259, 260
PROFESSIONAL MEN
Audit for, 311
PROFIT
On uncompleted contracts, 309, 310
On sale of stock received as dividends, 169
PROFIT AND LOSS ACCOUNT
How closed, 181, 182
How used, 181
PROFIT AND LOSS STATEMENT
In auditor's report, 387
PROFITS
Segregated, in building and loan associations, 277
PROMOTION EXPENSE
An indefinite deferred charge, 98
Nature of, 101
Written off rapidly, 102
PROOF
Of beginning inventories, 35
PROOF OF CASH-BOOK FOOTINGS
Schedule for, 8, 9
PROPERTY ADDITIONS
Auditor's test of, 74
PROPERTY LEDGER
Controlled by building account, 71
PROPRIETARY ACCOUNTS
For municipalities, 323, 324
PROPRIETORSHIP ACCOUNTS
Of an individual, 162
PUBLIC SERVICE COMPANIES
Audit, 247
PUBLISHERS
Audit of books for, 291
Classified, 291
Income of, 291
Of periodicals, 293, 294
Valuation of consignments, 292

QUANTITIES OF TIMBER CUT AND SOLD
Proof of, 298
QUESTIONS TAKEN FROM C.P.A. EXAMINATIONS
Accrued wages on balance sheet, 124
Analysis of general expense and pay roll, 210
Analysis of operating accounts, 199
Analysis of partners' accounts, 183
Annual statements of a municipality, 331
Audit of a partnership, 183
Audit of clubs, theaters, and hotels, 345
Audit of stock-broker's accounts, 274
Audit of trust-company accounts, 274
Auditor's attitude toward a defective cost system, 219
Auditor's report on discounted notes, 188, 189
Auditor's responsibility for bad debts previously reported, 140
Auditor's responsibility for correctness of notes payable, 116
Auditor's responsibility for discovered notes, 116
Auditor's responsibility for inventories, 54
Basis for valuing inventories, 54
Charges to a real estate account analyzed, 83
Classification of securities on balance sheet, 67
Cost or market basis for inventory, 54
Computation of reserve for discounts, 140
Consigned goods on balance sheet, 54
Consolidated balance sheet defined, 246
Construction charges for machine, 83
Definition of deferred charges, 67
Depreciation of plates in a publishing company, 89
Determination of claim against insurance company, 351
Determination of depreciation rates, 133
Determination of loss-paying ability in fire insurance company, 290
Dividends on balance sheet, 124
Dividends from subsidiary company in balance sheet, 246
Entries for a municipality, 331
Entries for notes discounted, 188
Estimate of inventory lost in fire, 54
Evidence of correctness of operating expenses, 219
Evidence of ownership of land, 74
Examination of officers' bonus, 210
Expenditures for land purchased, 74
Goodwill amortization, 95
How to determine reserve for bad debts, 26
Idle property on balance sheet, 75
Information for banker, purchasing bond issue of street railway company, 255
Inventory adjustment, 116
Lease amortized, 89
Liabilities in balance sheet, 116
Liability of accommodation indorser, 188
Machinery account audit, when machines are bought on installment plan, 83
Meaning and use of turnover, 54
Mortgages, examination of, 160
Note as evidence of payment, 115
Notes payable indorsed, 115
Notes payable verified, 115
Organization expense, 106
Paid checks as vouchers, 203
Patents at present values, 89
Peculiar features of municipal accounts, 331
Procedure of a bank audit, 274
Program of balance-sheet audit, 15

Reappraisal of capital assets, 83, 84
Relation of sinking fund to depreciation, 133
Reorganization of corporations, 183
Revenue of street railway company, 255
Scope of various kinds of audits, 6
Secret reserves, 140
Unrecorded claims, 188
Valuation of buildings, 74
Valuation of land, 74
Verification of accounts receivable, 25
Verification of bad debts written off, 140
Verification of capital stock, 183
Verification of cash balance, 15
Verification of interest payments on bond coupons, 124, 160
Verification of notes receivable, 26

RAILROAD DISBURSEMENTS
Analysis of, 250
RAILROAD INCOME
Audit of, 248, 249
RAILROADS
Classification of accounts of, 248
RATES
Of telephone companies, 256
RATES OF DEPRECIATION
Examined by auditor, 126
Various, 78
RATIOS
Accounts receivable to sales, 22
Important, in auditor's report, 389
RECONCILIATION STATEMENT
Bank, 9
RECORDED MORTGAGES
Examination of, 145
RECORDS OF METER READERS
Basis of consumers' charges, 258
REFINANCING
Auditor's problems connected with, 374
Illustrative problem, 376, 377
Procedure and legal requirements in Illinois, 376, 377
REFUNDS
Receivable from deposits on contracts, 25
REGISTERED BONDS
How examined, 63, 64, 145
REINSURANCE RESERVE
Liability of fire insurance companies, 289, 290
REORGANIZATIONS
Investigations for, 370
Problem of Federal income tax involved, 370
Types of, 372, 373
REPAIRS
An operating cost, 77
REPLACEMENTS AND RENEWALS
Charged to the reserve for depreciation, 77
REPOSSESSION
Of installment sales, 24
RESEARCH
For rates of depreciation, 127
RESERVE
For anticipated discounts, 137
For appreciation of land, 69
For assessed taxes, 122
For bad accounts, 134
For bad debts, 218
For doubtful claims, 25
For initiation fees, 277
For profits on sale of investments, in investment companies, 281
For shrinkage in values of securities, 63
For subsidiary assets valuation account, 242
For suspense accounts, 219
For unfinished contracts, 309
Reinsurance, in fire insurance companies, 289, 290
Sinking fund for depreciation, 136
RESERVE ACCOUNTS
Nature of, 125
RESERVE FOR ANTICIPATED DISCOUNTS
How determined, 137
RESERVE FOR APPRECIATION OF FIXED ASSETS
How used, 83
RESERVE FOR BAD ACCOUNTS
How to test adequacy of, 134
Purpose of testing, 134
RESERVE FOR BAD DEBTS
Based on past experiences, 21
RESERVE FOR DEPRECIATION
Adequacy of, 77
Not a liability, 126
RESERVE FOR LEGAL EXPENSE
Purpose of, 138
RESERVE FOR ROYALTIES
Need for, 138
RESERVE FOR SINKING FUND
An offset to sinking fund, 137
Protection to bond holder, 137
RESERVES
For depreciation, 73
For past-due notes receivable, 18
Surplus, 125, 126
Valuation, 125, 126
RESERVES FOR CONTINGENCIES
When created, 137, 138
RESULTS OF OPERATION
In audit report, 383, 384
RETIREMENT OF BONDS
Illustrated, 151
Two methods of, 145
RETURNS AND ALLOWANCES
Authorization for, examined, 215
REVENUES AND APPROPRIATIONS
In municipalities, 324, 325
ROYALTIES
Verification of, for automobile manufacturers, 319
Verification of, for mines, 301
RULES
For audit of liabilities, 113, 114
For business brokers, 283
For examination of bills under non-voucher system, 202, 203
For checking inventories, 27-32
For vouching, 200-202

SALARIES
How tested, 208, 211, 212
SALES
Elements of, in timber companies, 296
SALES ACCOUNTS
How audited, 194, 195
SALES DISCOUNTS
How treated, 194
Purpose of, 137
SALES OF APPLIANCES
By telephone companies, 259
SALESMEN'S EXPENSE REPORTS
Examination of, 212
SAVINGS BANKS
Verification of depositors' balances, 268
SCALING
Of timber cuttings, 298
SCHEDULE
For officers' and employes' accounts, 23
For proof of cash-book footings, 8, 9
For proving accounts-receivable total, 22
For proving beginning inventories, 35
For proving cash account, 12
Of accounts receivable, 20
Of mortgages, 142
Of notes payable, 107
SCHEDULES
For fixed assets, 68
Reconciliation of, with statements, 393
Supplementary to auditor's report, 387, 388
SECRET RESERVES
Auditor's attitude on, 139, 140
Definition, 138
Due to excessive depreciation, 132
How created, 138, 139
SECURED NOTES RECEIVABLE
Better than an open account, 16
SECURITIES
In transit, 62, 63
Investments in, 62
List of investments in, 62, 63
On hand, 62
Out as collateral, 62, 63
Speculative and nonspeculative, 375
Verification of, for savings banks, 268
SECURITIES ON MARGIN
Examination of, for brokers, 270
SELLING EXPENSE
Checked with salesmen's contracts 211,
Deferred, 104
When legitimately deferred, 105
When not to be deferred, 105
SELLING PRICES
Based on cost, not market, 34
SINKING FUND
In balance sheet, 136
Interest on, 149
Invested in securities, 66
Of municipalities, 66
When created, 65
SINKING FUND METHOD
Of depreciation, 131
SINKING FUND REQUIREMENTS
For serial retirements, 146-149
SINKING FUND RESERVE FOR DEPRECIATION
In balance sheet, 136
Not a liability, 136
SLOW ACCOUNTS
Reported to management, 22
SMALL TOOLS
Depreciation of, 79
Physical inventory of, 79
SPECIAL ASSESSMENTS
How to verify, 328
SPECIAL AUDITS
Illustrations of, 332
SPECIAL BUSINESS TYPES
Automobile manufacturers, 318-321
Bond and stock brokers, 270-273
Branch accounts, 302-304
Building and loan associations, 275-278
Business brokers, 282, 283
Contractors, 308-311
Department stores, 305-308
Financial institutions, 262-283
Fire insurance companies, 289, 290
Gas companies, 259, 260
Investment companies, 279-282
Life insurance companies, 285-289
Mines, 301, 302
National and federal reserve banks, 263-266
Oil mills, 315-317
Professional men, 311-314
Public-service companies, 247-255
Publishers, 291-295
Savings banks, 268-270
State banks, 266-267
Telephone companies, 256-259
Textile mills, 317, 318
Timber companies, 295-300
Water companies, 260
SPECIAL EXAMINATIONS
Cases requiring, 6
Limited by scope of engagement, 6
SPECIAL INVESTIGATION
For purchase or sale of a business, 379
Illustration of, 379, 380
SPECULATIVE SECURITIES
Nature of, 375
STATE BANKS
Audit of, 267
STATE REGULATION
Of insurance companies, 284
STATEMENT
Application of funds, 111
STATEMENTS
From creditors for notes payable, 108
STATION AGENTS' REPORTS
Examination of, 249
STATISTICS
Basis for deferring selling expense, 106
STOCK AND BOOK PLATES
Verification of, 292
STOCK DIVIDEND
Effect of, 168, 169
STOCK FRAUDS
Investigation of, 367-369

STOCK OF SUBSIDIARY
Purchased below book value, 241, 242
STOCK SUBSCRIPTIONS RECEIVABLE
Verification of, 25
STOCKHOLDERS' INTEREST
To be safeguarded, 132
STOCKHOLDERS' LIABILITY
In the case of banks, 164
STOCKS
Purchased from brokers, 64
STUMPAGE ACCOUNT
In timber companies, 295
SUBCONTRACTORS
Examination of charges by, 310, 311
SUBSIDIARY COMPANY
May be a holding company, 245
SUNDRY ACCRUED ACCOUNTS
Illustrated, 122
Recognition of, 122
SUNDRY REVENUES
Of a municipality, 328, 329
SURPLUS ACCOUNT
Adjusted for inadequate depreciation, 166
Analysis of, 167
Part of net worth, 166
When to be adjusted, 167-169
SURPLUS CHARGES
For extraordinary expenses, 206
SURPLUS FROM UNREALIZED APPRECIATION
How used, 83
SURPLUS RESERVES
Appropriations of surplus, 125, 126
Nature of, 135, 136
On the balance sheet, 136
SUSPENSE LEDGER
For bad debts, 218
SYSTEM INSTALLATION
Special investigations for, 381
SYSTEMATIZER
Nature of his work, 381

TAXES
Accrued, 121
For prior years, 121, 122
TELEPHONE COMPANIES
Subject to public service commissions, 256
Typical expenses of, 257
TELEPHONE RATES
Examination of, for telephone companies, 258
TEST
Of inventories, by partial counts, 27
TESTING LEDGER ACCOUNTS
To prove cash account, 13
TEST QUESTIONS
On essential points, 3, 6, 15, 25, 26, 54, 67, 74, 75, 83, 84, 89, 95, 106, 115, 116, 124, 133, 140, 160, 183, 188, 189, 197, 203, 210, 219, 228, 233, 246, 255, 261, 267, 274, 283, 290, 300, 304, 314, 322, 331, 340, 345, 351, 359, 360, 369, 381, 382, 389.
TESTS
For deferring selling expense, 105
Of checks, 10
TEXTILE MILLS
Audit, 317, 318
Costs standardized in, 317
THEATERS
Auditing procedure for, 344, 345
Source of income, 344
TIMBER COMPANIES
Audit, 295
Camp pay rolls, 299
Cutting and driving expense of, 298, 299
Depreciation of equipment, 299
Stumpage account in, 295
TIME AND EXPENSE REPORTS
How used, 392
TOTAL CASH DISBURSEMENTS
How proved, 229
TOTAL CASH RECEIPTS
How proved, 229, 230
TRADE ACCEPTANCES RECEIVABLE
More easily discounted than notes, 20
Same as promissory notes, 20
When used, 19, 20
TRADE DISCOUNTS
Not charged to customers, 137
TRADE-MARKS AND COPYRIGHTS
Combined with good will, 88
Value of, 87, 88
TREASURY STOCK
Distinguished from unissued stock, 165
Examination, 166
In balance sheet, 165, 166
TRUST COMPANIES
Main activities, 269
Nature of audit, 269
TRUSTEES' AND EXECUTORS' ACCOUNTS
Legal requirements, 332
TURNOVER
Of cash, 14

UNCOMPLETED CONTRACTS
Profit on, 309, 310
UNEARNED BURDEN
Kept at a minimum, 71
UNFILLED CONTRACTS
Contingent liability, 186, 187
UNFINISHED CONTRACTS
How to verify, 310
Reserve for, 309
UNIFORM ACCOUNTING
Bulletin of, 28
UNIMPROVED REAL ESTATE ACCOUNT
Credits to, 70
Charges to, 70
UNIMPROVED REAL ESTATE LEDGER
At cost, 70
UNITED STATES SUPREME COURT
Ruling on stock dividends, 169
UNREDEEMED TICKETS
Analysis of, 159
UNSALABLE GOODS
How valued, 49

VALUATION
How to determine, for inventory in fire loss, 349, 350
Of copyrights, 293
Of goods in process, 41-43
Of goods taken in exchange, 53
Of inventories, 33, 34
Of inventories for income tax purposes, 40
Of investments in investment companies, 281
Of securities, 63, 64
VALUATION OF INVENTORIES
Attitude of business men, 33
Tested by gross profit percentage, 347, 348
VERIFICATION
Of accrued interest, 120
Of balance per bank statement, 9
Of bond account, 143
Of capital stock outstanding, 165
Of capital stock oustanding, 166
Of cash account, 8
Of cash and securities for broker, 272
Of cash sales in department stores, 305, 306
Of C.O.D. sales in department stores, 306
Of departmental charges for expense, 307, 308
Of depositors' balance in savings banks, 268
Of disbursements in universities, 336, 337
Of factory costs, 217, 218
Of footings and postings, 229
Of income for electric roads, 251
Of income for investment companies, 280
Of income for publishers, 291
Of income for universities, 339, 340
Of income from advertising, 294
Of income from fines, 276
Of income from restaurants, 342
Of income from securities in investment companies, 280
Of interest on loans in building and loan associations, 275
Of inventories, 27-32
Of inventories, 37
Of inventories for publishers, 291
Of investments for life insurance companies, 287, 288
Of liabilities, in life insurance companies, 288, 289
Of municipal revenues, 328, 329
Of notes on contracts, 110
Of outstanding checks, 10
Of passenger revenue, 248
Of premiums, in life insurance companies, 286
Of prepaid insurance account, 57
Of prepaid taxes, 61
Of purchases in department stores, 306
Of refunds on deposits on contracts, 25
Of royalties of automobile manufacturers, 319
Of sales in wholesale and retail business, 195
Of securities, 62, 63
Of securities in savings banks, 268
Of sinking funds, details, 65
Of stock and book plates, 292
Of trade acceptances receivable, 20
Of unfinished contracts, 310
Of university investments, 340
Of unsold lots, 71
Of yield, in oil mills, 315
Procedure for notes receivable, 16
VOUCHER REGISTER
Compared with vouchers, 200
VOUCHER REGISTER DISTRIBUTION
Examination of, 200
VOUCHER SYSTEM
Audit of, 114
Expense audit under, 198
VOUCHERS
Compared with register, 200
Examination of, 199
For extraordinary expenses, 207
VOUCHING
Dependent upon subsidiary books and correspondence, 232
Mainly to verify distribution, 232
VOUCHING EXPENSES
Procedure for, in department stores, 306, 307

WATER COMPANIES
Examination of rates of, 260
WORKING CAPITAL
Formula for, in building and loan associations, 277
WORKING PAPERS
Arrangement of, 390
How to preserve, 391
Illustrated, 431

ILLUSTRATIVE AUDIT WORKING PAPERS

In the following reproduction of the audit working papers and the formal report derived from them, which has just been presented, an effort has been made to assist the reader to understand more clearly the practical accomplishment in an audit, and the technical process in building up the working papers. An actual case has been selected, the accounts and the relationships between the figures being taken from the original papers.

These papers are typical of the average situation which forms a large part of the auditor's duties. The practicing accountant will not, however, find them free from defects as compared with the ideal.

If an audit were made for the first time, there would appear certain working papers covering the history and the organization of the company, the creation of good-will (if any) or sinking fund provisions, etc. Such papers will not be found in this audit, since a previous audit has been made by the same practicing accountants. Generally the working papers of the previous audits are used in all subsequent audits, and are sometimes taken by the auditor to the client's office where he does his work so that any necessary reference may be made.

The following working papers are not as complete as they originally appeared, since all the financial statements and text of the report as originally prepared in handwriting by the auditor have been omitted. The model audit report previously illustrated has been typed from these original papers.

After an audit is completed the working papers should be carefully indexed so that reference to them may be readily made by any member on the public accountant's staff other than the one who made the audit. The careful student will be guided into a detailed study of the case, and it is hoped he will find many helpful points which practical experience gives to the auditor.

J O H N S O N B R O S. A N D C O M P A N Y

AUDIT WORKING PAPERS

AS OF DECEMBER 31, 1924.

Senior Fred Joslyn

Junior Geo Moore

INDEX TO WORKING PAPERS

A ORIGINAL DRAFT OF REPORT

B FINANCIAL STATEMENTS

B 1 - Balance Sheet

B 2 - Statement of Income, Profit and Less

B 3 - Statement of Cost of Sales

B 4 - Comparative Balance Sheet

B 5 - Comparative Statement of Cost of Sales

B 6 - Comparative Statement of Income, Profit and Loss

B 7 - Statement of Application of Funds

B 8 - Analysis of Surplus

(The original draft of the report and the financial statements have been omitted from the working papers to avoid repetition. They will be found in typed form in the Audit Report)

C 1-3 WORKING TRIAL BALANCE

D 1-4 ADJUSTING JOURNAL ENTRIES

E SCHEDULES OF BALANCE SHEET ACCOUNTS

E 1 Bank Reconciliations

E 1a Illinois Savings Bank General Account

E 1b Illinois Savings Bank Pay Roll Account

E 1c Bankers Loan and Trust Company Account

E 1d Letter to Illinois Savings Bank

E 1e Letter to Bankers Loan and Trust Company (omitted)

E 1f Reply from Illinois Savings Bank

E 1g Reply from Bankers Loan and Trust Company

E 2 - Liberty Bonds and Accrued Interest

E 3 - Accounts Receivable- Customers

E 4 - Accounts Receivable- Individuals

E 5 - Inventories on Hand

E 6 - Unexpired Insurance

E 7 - Prepaid Taxes

E 8 - Cragen Plant Buildings and Depreciation

E 9 - Analysis of Additions to and Deductions from Cragen Office Building

E 10 - Depreciation- Cragen Office Building

E 11 - Deferred Charges- New Roof

E 12 - Analysis of Additions to and Deductions from Machinery and Equipment

E 13 - Reserve for Depreciation- Machinery and Equipment

E 13a - Machinery and Equipment on Hand for Sale

E 13b - Analysis of Depreciation on Machinery and Equipment

E 14 - Analysis of Additions to and Deductions from Motor Truck Account

E 15 - Depreciation- Motor Trucks

E 16 - Analysis of Additions to and Deductions from Office Furniture and Fixtures

E 17 - Reserve for Depreciation- Office Furniture and Fixt.

E17a Analysis of Depreciation- Office Furniture and Fixt.

E 18 - Analysis of Additions to Lunch Room Equipment

E 19 - Depreciation- Lunch Room Equipment

E 20 - Vouchers Payable

E 21 - Accrued Wages and Salaries

E 22 - Accrued Taxes

E 23 - Liability Insurance

E23a Rates Used on Employees Liability and Public Liability

E 24 - Reserve for Land Value Adjustment

E 25 - Analysis of Surplus Account

F SCHEDULES OF PROFIT AND LOSS ACCOUNTS

F 1 - Analysis of Loss and Gain on Fixed Properties

F 2 - Analysis of Obsolete Machinery Sold

F 3 - Executive Salaries

F 4 - Donations

F 5 - Bad Debts Charged off during the Year 1924

F 6 - Bad Debts Recovered during Year 1924

G MISCELLANEOUS PAPERS

G 1 Audit Program

G 2 - Abstract of Important Matters in Minutes of Directors and Stockholders (omitted)

G 3 - List of Officers, Executives and Accounting Records (omitted)

G 4 - Miscellaneous Memoranda (omitted)

Johnson Bros and Company
Working Trial Balance, December 31, 1924

Accounts	Trial Balance (per Ledger) Dr.	Trial Balance (per Ledger) Cr.	Auditor's Adjustments Dr.	Auditor's Adjustments Cr.	Manufacturing Dr.	Manufacturing Cr.	Selling Dr.	Selling Cr.	Profit and Loss Dr.	Profit and Loss Cr.	Balance Sheet Dr.	Balance Sheet Cr.	Schedule No
Bankers Loan & Trust Co	210749.96										210749.96		E 1
Illinois Savings Bank	5495.16										5495.16		E 1
Accounts Rec. - Customers	156706.30										156706.30		E 3
Accounts Rec. - A. F. Johnson	90000.00										90000.00		E 4
Accounts Rec. - Individuals	4321.71										4321.71		" "
Claims - Federal Tax	2149.92		(9) 8250.15	(10) 2291.71									
			(9) 141.80	(11) 1931.97							6318.19		D2 - D3
Inventory - Raw Materials	10866.15										10866.15		E 5
Inventory - Work in Process			(5) 19649.11								19649.11		E 5
U. S. Govt. 3rd Liberty - 4¼	37000.00										37000.00		E 2
U. S. Govt. 4th Liberty - 4¼	35000.00										35000.00		E 2
Accrued Interest on Liberty Bonds	768.54										768.54		E 21
Land - Water St.	58752.51										58752.51		
Land - Crapen District	74067.57										74067.57		
Buildings - Water St. Plant	2116.54										2116.54		
Buildings - Crapen Plant	247891.42										247891.42		E 8
Buildings - Crapen Office	52726.19										52726.19		E 9
Buildings - Lunch Room Equip	708.12										708.12		E 18
Machinery & Equipment	398006.41										398006.41		E 12
Trucks	10746.29			(8) 6180.71							4565.58		E 14
Office Furn. & Fixt.	12124.39										12124.39		E 16
Machinery & Equip. on Hand for sale	10278.42			(1) 1300.00									
				(12) 8978.42									
Patents	1.00										1.00		
Goodwill	200000.00										200000.00		
Unexpired Insurance	55.42										55.42		E 6
Prepaid Taxes	312.00		(13) 671.50								983.50		E 7
Deferred Charges Misc.	21776.65										21776.65		E 11
Vouchers Payable		6454.35										6454.35	E 20
Accrued Wages & Salaries		4408.83										4408.83	E 21
Accrued Real & Personal Taxes		14213.71										14213.71	E 22
Accrued Insurance		4955.37										4955.37	E 23 - 23a
Capital Stock		100000.00										100000.00	
Surplus		108735.72	(11) 1300.00	(6) 532.79									
				(8) 8250.15									
			(4) 3336.40	(9) 141.80									
			(10) 2291.71	(13) 671.50									
			(12) 8978.42									532.79	
												108203.64	E 25
Reserve for Depreciation - Bldg. Crapen		52792.66										52792.66	E 8
Reserve for Depreciation - Office Bldg		3010.64		(2) 3600								3046.64	E 10
Reserve for Depreciation - Bldg - Lunch Room		438.23										438.23	E 19
Reserve for Depreciation - Furn. & Fixt.		7447.91	(6) 783.89									6664.02	E 17
Reserve for Depreciation - Mach. & Equip.		200177.80	(7) 2727.39									197450.41	E 13
Reserve for Depreciation - Trucks		7330.42	(8) 6190.71									1139.71	E 15
Reserve for Land Value Adj.		11666.92										11666.92	E 24
Inventory - Work in Process 1/1/24 (Adj.)	55663.83			(5) 19649.11	55663.83	19649.11							
Loss & Gains on Obsolete Mach. sold	728.86								728.86				F 2
Loss & Gains on Sales of Capital Assets		1122.67								1122.67			F 1
Gross Sales		948674.84						948674.84					
Totals Forwarded to Page 2	1700002.36	2450430.07	532.79 / 53788.29	532.79 / 49441.37	55663.83	19649.11		948674.84	728.86	1122.67	1651628.42	1484756.28	

Johnson Bros and Company
Working Trial Balance, December 31, 1924

	Trial (per Dr	Trial (per Cr	Balance Ledger) Dr	Balance Ledger) Cr	Auditor's Adjustments Dr	Auditor's Adjustments Cr	Manufacturing Dr	Manufacturing Cr	Billing Dr	Billing Cr	Profit and Loss Dr	Profit and Loss Cr	Balance Sheet Dr	Balance Sheet Cr	Schedule No.
Totals Forwarded from Page 1	1,700,002.36		2,450,430.07		532,179.29	532,179.29	556,603.83	19,649.11		948,674.84	728,86	1,122.67	1,651,829.42	1,484,766.28	
Direct Labor - Misc. Inside	122,489.70						122,489.70								
" " - Accomodations	37.81						37.81								
" " Casting etc Outside - Illinois	12,332.41						12,332.41								
" " " " Indiana	2,329.35						2,329.35								
" " " " Wisconsin	445.00						445.00								
" Blast Furn Construction Iron & Steel Wk - Illinois	13,189.76						13,189.76								
" " " " " " "	6,023.02						6,023.02								
" " " " " " " Indiana	50,737.21						50,737.21								
" Iron & Steel " Smoke Stacks "	6,711.54						6,711.54								
Materials	283,883.42						Cor. 7449.10 276,434.32								
Purchases for Accommodations	219.86												219.86		E 4
Freight on Materials Purchased	677.48						677.48								
Indirect Labor - Tool Room	3,658.20						3,658.20								
" " Time Keeper Shipping Clk	2,487.17						2,487.17								
" " Boiler Shop Foreman	884.33						884.33								
" " Superintendent	4,722.00						4,722.00								
" " Machine Shop Foreman	3,410.33						3,410.33								
" " Pattern Makers	2,144.70						2,144.70								
" " Engineer	2,528.33						2,528.33								
" " Oiler & Motor Tender	2,140.98						2,140.98								
" " Watchman	1,651.67						1,651.67								
" " Misc.	16,441.91						16,441.91								
" " Layer Out	3,486.75						3,486.75								
Depreciation - Bldgs. Cranes	3,718.22						3,718.22								
" - Machinery & Equip.	15,526.45					(1) 2,727.39	12,799.06								
" - Motor Trucks	1,111.58						1,111.58								
Insurance - Bldgs & Contents	516.39						516.39								E 6
" - Trucks	822.02						822.02								E 23
" - Pay Roll Liability	721.31						721.31								E 23
" - Public Liability	65.07						65.07								
Taxes - Real & Personal Property	17,550.11					(1) 2,336.40	14,213.71								E 7
" - Trucks	312.00						312.00								
Water	394.75						394.75								
Coal & Coal Freight	2,174.21						2,174.21								
Fuel Oil & Fuel Oil Freight	17,678.97						17,678.97								
Gasoline & Oil Factory	1,088.83						1,088.83								
Electric Current	3,968.90						3,968.90								
Gas	3,082.31						3,082.31								
Electrical Repairs	329.53						329.53								
Maintenance - Bldg. Cranes Floors	4,386.41						4,386.41								
" - Water St.	101.74										101.74				
" Machinery & Equip.	11,020.81						11,020.81								
Small Tool Replacements & Repairs	4,768.44						4,768.44								
Patterns	1,251.47						1,251.47								
Shop Expense - Misc.	2,516.63						2,516.63								
Drafting Room Expense	80.30						80.30								
Freight & Express - Misc.	136.20						136.20								
Maintenance of Trucks	418.06						418.06								
Truck Chauffeurs Salaries	3,383.78						3,383.78								
Totals Forwarded to Page 3	2,354,586.78		2,450,430.07		532,179.29	532,179.29	555,605.16	703,986.86	19,649.11	948,674.84	830.60	1,122.67	1,651,829.42	1,484,766.28	

Johnson Bros and Company

Working Trial Balance, December 31, 1924

Accounts	Trial Balance (per Ledger) Dr.	Trial Balance (per Ledger) Cr.	Auditors Adjustments Dr.	Auditors Adjustments Cr.	Manufacturing Dr.	Manufacturing Cr.	Selling Dr.	Selling Cr.	Profit and Loss Dr.	Profit and Loss Cr.	Balance Sheet Dr.	Balance Sheet Cr.	Schedule No.
Totals Brot Forward from Page 2	2,354,585.78	2,450,430.07	53,788.29	532.79 55,605.16	703,861.86	196,419.11		948,674.84	930.60	1,122.67	1,651,849.28	1,484,256.28	
Fire Damage		150.00				150.00							
Salesmen's Salaries	2,927.33						2,927.33						
Commissions Paid to Salesmen	250.00						250.00						
Out-freight on Sales	7,387.13						7,387.13						
Travelling Expense-Selling	1,587.39						1,587.39						
Advertising	948.75						948.75						
Entertaining	2,177.14						2,177.14						
Misc. Selling Expense	82.50						82.50						
Maintenance of Automobiles	415.02						415.02						
Executive Salaries	42,500.00								42,500.00				F 3
Salaries-Clerical Office & Janitor	17,749.06								17,749.06				
Capital Stock Tax (Federal & State)	1,343.00								1,343.00				
Stationery and Office Supplies	1,207.46								1,207.46				
Telephones	963.32								963.32				
Telegrams	37.85								37.85				
Postage	134.52								134.52				
Auditing & Appraising	1,291.50								1,291.50				
Legal Expense	1,601.13								1,601.13				
Electrical Repairs & Replacements	21.72								21.72				
Maintenance-Office Bldg. (Janitor)	272.87								272.87				
" Lunch Room	2.40								2.40				
Fuel-Office Heating	1,387.20								1,387.20				
Depreciation-Office Furn. & Fixt.	1,171.33			(6) 251.10					920.23				
Insurance-Vault Contents	9.34								9.34				
Donations	2,355.00								2,355.00				F 4
Dues & Subscriptions	1,134.00								1,134.00				
Freight & Express-Misc.	15.27								15.27				
Pensions	1,767.00								1,767.00				
Traveling Expense-Admn	264.70								264.70				
Misc. Administrative Expense	1,102.35								1,102.35				
Maintenance-Office Furn. & Fixt.	100.83								100.83				
Bad Accounts	9,388.00								9,388.00				F 5
Depreciation-Lunch Room Equip.	141.40								141.40				
" -Office Bldg.	784.48		(2) 36.00						784.48				
Interest Earned		589.29								589.29			
Discount on Purchases		1,551.08								1,551.08			
Bad Accounts Recovered		75.00								75.00			F 6
Income from Rents		2,322.00								2,322.00			
Interest on Bank Balances		2,262.30								2,262.30			
Misc. Additions to Income		5.00								5.00			
Interest on Liberty Bonds 3½%		1,572.50								1,572.50			
" " " " 4th 4¼%		1,487.50								1,487.50			
Collection Fees & Other Charges	12.73								12.73				
Allowance on Sales	3,361.24								3,361.24				
Interest Expense			(1) 1,931.97						1,931.97				
Cost of Sales						684,062.75	684,062.75						
Gross Profit after Selling Exp.							248,836.83			248,836.83			
Net Profit for Year									167,193.00			167,193.00	E 25; B2
Grand Totals	2,460,444.74	2,460,444.74	55,756.26	532.79 55,756.26	703,861.86	703,861.86	948,674.84	948,674.84	259,824.17	259,824.17	1,651,849.28	1,651,849.28	

Johnson Bros. and Company
Adjusting Journal Entries at December 31, 1924

(1.)			
Surplus	1300.00		
Machinery & Equipment on Hand for Sale			1300.00
To correct entry of June, 1923 on sale of roll Binders to C. M. & St. P. R.R. for $900.00, which were included in account "Machinery & Equipment on Hand for Sale" at $1300.00. Entire proceeds of $900.00 was credited to account "Loss & Gain on Sale of Capital Assets" whereas a loss of $400.00 should have been charged off.			
(2.)			
Depreciation	36.00		
Reserve for Depreciation-Office Building			36.00
To adjust your journal entry #277. Charging depreciation on the above building you charge $748.44 whereas the correct amount should be $784.44			
(3.)			
Reserve for Depreciation-Trucks	619.71		
Truck Account			619.71
To adjust the asset and reserve account due to one Packard truck being fully depreciated.			
(4.)			
Surplus	3336.40		
Taxes-Real and Personal			3336.40
To eliminate the amount of 1923 real estate tax which were paid in excess of the amount accrued at 12/31/23. This excess should be charged to surplus instead of operations in 1924			
(5.)			
Inventory-Work in Process	19644.11		
Manufacturing			19644.11
To set up work in process inventory December 31, 1924.			
(6.)			
Reserve for Depreciation-Furn. & Fixt.	783.89		
~~Depreciation-Office Furn. & Fixt.~~			251.10 532.79
To adjust for excessive depreciation charged off as shown by depreciation schedule.			

Johnson Bros. and Company
Adjusting Journal Entries at December 31, 1924

(7)			
Reserve for Depreciation-Mach'y & Equip. Manufacturing	2,727.39		
To Adjust for Excessive depreciation charged off as shown by depreciation schedule			2,727.39
(8)			
Claims-Federal Taxes	8250.15		
Surplus			8250.15
To restore as a claim for refund the amount which was taken as a claim for credit against the unpaid portion of the 1920 tax upon notice from the collector of Internal Revenue that this claim for credit being for an overpayment of interest on 1918 deficiency could not be applied against taxes unpaid and therefore the unpaid portion of 1920 taxes above would be collected and the overpayment of interest separately refunded. This amount will increase the claim for refund from $2,149.92 on the books to $10,400.07 which is total originally claimed as overpaid as follows:			
5% penalty on 1918 tax $2,291.71			
Amount originally conceded 2087			
Net originally claimed ($204.84			
Interest paid on 1918 deficiency $8,250.16			
Amount originally conceded 110.93			
Net originally claimed (8,139.23			
Total " " (Included below) $10,400.07			
Claim for refund $2,149.92			
" " credit 8,250.15			
$10,400.07			
(9)			
Claims-Federal Taxes	141.80		
Surplus			141.80
To increase claims from amount originally claimed to amount finally allowed which was the full amount of penalty and interest paid, the difference being the amounts shown above, as as originally conceded as follows:			
Portion of penalty $3087			
Portion of interest 110.93			
$141.80			

Johnson Bros and Company
Adjusting Journal Entries at December 31, 1924

(9) (cont'd.)
The above was allowed on certificate #224962 on schedule #8905. The portion of interest as above, $110.43 was originally charged to Interest Expense in 1921 when paid but was disallowed as a deduction by Revenue Agent Scott in his audit of 1919 to 1921 and is therefore now credited to Surplus.

(10.)

Surplus	229.71	
Claims - Federal Taxes		229.71

To adjust accounts for payment of Federal Income Tax June 9, 1924 as follows:

Balance due on 1918 original return	$ 22628.27
Less - Over assessment of 1918 penalty included in Claim Account and applied as part payment	229.71
Net amount paid 6/9/24	$ 20336.56

The balance of claim for refund after above credit $8250.16 represents the amount of interest at 1% per month on the 1918 deficiency which was paid in 1921 and which is refundable by the Collector

(11)

Interest Expense	193.97	
Claims - Federal Taxes		193.97

To record amount of interest charged by Collector of Internal Revenue on balance of 1918 tax paid 6/9/24, the interest charge being deducted by the collector from the refundable interest of $8250.16 making a net amount to be refunded of $6,318.19 certified to Washington for refund on Sept. 3, 1924

(12.)

Surplus	8978.42	
Machinery & Equip on Hand for Sale		8978.42

To write off balance of this account as there remains nothing of a salable nature

Johnson Bros. and Company
Adjusting Journal Entries at December 31, 1924

(13)			
Prepaid Taxes		671.50	
Surplus			671.50
To set up one half of the franchise and capital stock taxes paid in 1924 for the period from 7/1/24 to 6/30/25. The credit is made to Surplus because the prepaid amount was not set up at the end of the previous year and the amount charged to Taxes account is the same as would have been shown had this adjustment been made in regular order.			

E1a

Johnson Bros and Company

Reconciliation of Illinois Savings Bank Balance at December 31, 1924

Balance per bank statement Dec. 31, 1924	$	5495.16
Balance per ledger Account Dec. 31, 1924		5495.16

Above verified by letter from Illinois Savings Bank, dated Feb. 10, 1925

C. L. L.

Johnson Bros and Company
Reconciliation of Illinois Savings Bank
Pay Roll Account Balance at December 31, 1924

Outstanding checks number	amount	Check number	amount	Check number	amount	Check number	amount
			1443 97		2505 27		3702 89
26,533	35 00	31 906	21 46	31 958	17 85	32 007	22 20
7,860	27	7	18 50	9	21 00	8	26 64
8,943	31 5	8	32 30	60	19 61	9	27 38
9,594	75	9	19 95	1	24 00	11	18 00
877	7 00	10	6 40	2	35 62	2	30 36
30,128	25 00	1	24 00	3	24 00	3	36 02
1,342	27 50	3	29 70	4	19 20	4	36 80
486	34 85	5	25 16	5	19 20	6	27 00
513	28 00	6	33 30	6	20 44	7	19 12
68	20 00	7	25 16	7	24 00	8	28 12
90	4 50	8	25 90	8	22 80	9	20 70
690	17 42	20	25 90	9	30 36	20	20 35
3	42 50	1	23 80	70	25 50	3	4 50
9	38 25	2	18 50	1	24 64	4	16 64
703	31 50	3	27 75	2	24 64	5	21 12
17	25 00	4	19 61	3	12 60	6	25 55
28	40 85	5	16 79	4	27 20	7	18 50
40	32 50	6	20 40	5	19 08	9	19 80
1	66 55	7	26 64	6	19 61	30	13 75
64	30 00	8	18 50	7	18 50	1	30 36
72	63 00	9	5 50	8	28 16	2	19 12
95	37 84	30	52 [illegible]	9	27 01	3	26 25
9	25 00	1	16 [illegible]	80	18 50	4	36 50
810	32 40	2	38 50	1	18 50	5	28 16
19	29 40	3	32 00	2	14 02	6	28 98
22	37 00	4	20 35	3	20 40	7	27 72
53	68 20	5	18 50	4	28 60	41	30 00
62	24 00	6	20 35	5	31 05	2	30 00
8	65 00	7	18 50	6	15 75	4	28 00
73	47 50	8	2 50	7	24 00	5	26 00
83	45 10	9	19 50	8	18 50	6	26 00
5	31 02	40	20 40	9	17 60	7	24 00
6	47 50	1	20 35	90	32 12	9	10 00
8	25 90	2	25 50	1	12 75	51	85 00
90	27 38	3	20 35	2	49 20	2	65 00
1	34 00	4	20 35	3	18 00	3	65 00
3	28 50	5	36 90	4	18 50	4	55 00
4	28 49	6	21 60	5	44 50	5	50 00
5	22 31	7	20 35	6	46 58	7	47 50
6	36 00	8	49 05	7	26 64	9	45 00
7	31 50	9	24 64	8	28 80	60	40 00
9	23 31	51	24 00	9	31 85	1	25 00
401	23 80	2	20 35	32 000	50 80	2	22 20
2	20 40	3	19 20	1	25 90	3	14 00
3	24 22	5	21 60	3	21 09	5	84
4	28 12	6	19 24	4	29 60		5 021 07
5	28 49	7	14 80	5	22 75		
	1443 97		2505 27	6	24 60		
					3702 89		
Check 29927 and 30461 issued to Joe Felder				Check 29927 was stopped on			
account of being lost. Check was paid back Felder before stop order							
was issued. Felder was debited on payroll of week ending Jan 16, 1925							25 00
Balance as per bank certificate dated Feb 12, 1925 attached							$ 4996 07

E1c

Johnson Bros and Company
Reconciliation of Bankers Loan & Trust Company
Balance December 31, 1924

Balance per bank certificate attached			214,223.73
Deduct - Outstanding Checks:			
	Check No.	Amount	
	B 2667	12.00	
	2668	5.00	
	2669	9.00	
	2670	7.50	
	63 399	3.79	
	788	70.29	
	840	1.40	
	1	53.00	
	7	75.00	
	8	227.00	
	51	25.00	
	3	17.14	
	4	29.35	
	6	25.91	
	7	2.45	
	62	13.91	
	6	49.45	
	7	9.90	
	9	32.78	
	76	31.40	
	7	12.30	
	9	9.17	
	80	5.00	
	1	36.00	
	2	1000.00	
	3	217.00	
	4	53.01	
	5	6.70	
	6	357.71	
	7	97.02	
	8	7.04	
	9	3.00	
	90	138.41	
	1	2.16	
	2	.38	
	3	40.00	
	4	8.33	
	5	3.00	
	6	13.46	
	7	7.00	
	8	3.91	
	9	750.00	3,482.77
12/31/24 Balance as per ledger and Balance Sheet			$ 210,740.96

Copy of Letter sent to Banks by
the Client for the Auditor

E 1d

JOHNSON BROS. AND COMPANY
Boiler Manufacturers

CHICAGO, February 3, 1925

Illinois Savings Bank
2088 East 63rd Street
Chicago, Ill.

Gentlemen:

Please certify to our auditors, Messrs. Brown, Smith & Company, 1464 Commerce Building, Chicago, the amount of cash on deposit with you at the close of business, December 31, 1924, and also whether or not we were directly or contingently liable to you on that date and the amount of such liability in detail.

Yours respectfully,

JOHNSON BROS. AND COMPANY

Geo. A. Johnson
Secretary

CES:DVB

E1f

ILLINOIS SAVINGS BANK

Capital and Surplus $700,000.00

CHICAGO February 10, 1925

CERTIFICATE OF CREDIT BALANCE

This is to certify that there was on deposit in the ILLINOIS SAVINGS BANK, at the close of business, December 31, 1924 to the credit of the various accounts of JOHNSON BROS. AND COMPANY, the following sums:

Johnson Bros. and Company General Account	$5,495.16
Johnson Bros. and Company Pay Roll Account	4,996.07

ILLINOIS SAVINGS BANK

By William B. Stone
Cashier

P. S.
We carried no indebtedness of this company on that date.

E 1g

BANKERS LOAN & TRUST COMPANY

CHICAGO February 11, 1925.

Brown Smith & Company,
1464 Commerce Building,
Chicago, Ill.

Gentlemen:

As requested, we hereby certify to the following as shown by our books at the close of business December 31, 1924 in connection with Johnson Bros. and Company:

1. Balance at their credit:
   Two Hundred Fourteen Thousand Two Hundred Thirty Three Dollars and Seventy Three Cents, ($214,233.73).

2. Bills Payable to this bank:

   None

3. Securities Held as collateral:

   None

4. Bills Receivable discounted:

   None

5. Securities held as safekeeping:

   None

Yours very truly,
H. G. Ellingwood
H. G. Ellingwood,
Auditor

E2

Johnson Bros and Company
Schedule of Liberty Bonds and Accrued Interest
at December 31, 1924

Description	Amount	Accrued Interest
Third Liberty Loan - 4¼%	$ 37,000.00	$ 458.64
Fourth Liberty Loan - 4¼%	35,000.00	309.90
	$ 72,000.00	$ 768.54

Johnson Bros. and Company
Accounts Receivable, Customers
December 31, 1924

	Trial Balance	Current 30 Days	60 Days	90 Days	3 to 6 Months	6 Months to One Year	Over One Year	Remarks
Adams & Brown Co	4218.63					4218.63		Credit Pd 7/4/25 2505.60
Acme Heating Co	50.00						50.00	
Leavitt and Jones	508.00	508.00						Pd 1/6/25
Ajax Manufacturing Co	535.96	535.96						" 1/16/25
Central Iron & Steel Co	360.48	360.48						" 1/13/25
American Painters	12.60		12.60					" 7/6/25
Brown Supply Co	2900.00	2900.00						
Burrows Co	76.50	76.50						" 1/29/25
Bushell Steel Co	64.00	64.00						" 1/13/25
Busse & Sons J. R	6.00			6.00				" 1/16/25
Butler Coke Co	3455.55	3018.55	437.00					" 7/27/25
Central Drainage Co	94.80		94.80					" 1/6/25
Chase and Rus Co	27.34	27.34						" 1/6/25
Chicago & Penn R.R	290.50	290.50						" 1/6/25
Chicago Bus Co	571.97					571.97		" 7/6/25
Chicago Woodworking Co	9.50	9.50						" 1/27/25
City Building	227.85	227.85						" 1/29/25
Cole, Mrs Clayton	2.45	2.45						" 1/6/25
Col. Steel Co	105.60	105.60						" 1/27/25
Eastern Liability Assoc.	6.00	6.00						" 1/13/25
Empire Hospital Assoc.	18.90	18.90						" 1/16/25
Fairbanks & Co	674.62	674.62						" 1/27/25
Fuller Plate Glass Co	23.63	10.85	12.78					" 1/26/25
Garry Building	6.80	6.80						" 1/29/25
Gerle, John F.	15.30				15.30			
Gorman Painting Co	105.00	105.00						" 1/16/25
Grave, H L	800.00						800.00	
Hennesy Hospital	39.80	39.80						" 1/27/25
Hinkel, L O	7.75	7.75						" 1/23/25
Hollingsby Ralph	34.95	34.95						" 1/16/25
Hubbard Foundry Co	986.00	986.00						" 7/9/25
Illinois Castings Co	9012.19	2204.13	6808.06					
" " "	163.80			163.80				" 7/11/25
Ingram Construction Co	6.94	6.94						
Inland Foundries Inc								93.88 To Rec'd Pd
" " "	34887.53	34887.53						Pd 1/24/25
" " "	7027.30	7027.30						" 1/27/25
Jones & Eaton Steel Corp.	230.20	230.20						" 1/24/25
Ketchum Theatre	13.74	13.74						" 1/6/25
Klehm Co. Geo. H	842.30	16.60	825.70					" 7/24/25 $500.00
Kreller Shipyards & Dock Co	5.25	5.25						" 1/27/25
Lakewood Inn	366.20	366.20						
La Salle Christian Church	38.03						38.03	
La Claire Iron Works	199.79	199.79						" 1/27/25
Lyceum Co	109.80	109.80						" 1/13/25
Totals Forwarded	69139.55	55084.88	8190.94	169.80	15.30	4790.60	888.03	

Johnson Bros. and Company
Accounts Receivable — Customers
December 31, 1924

	Trial Balance	Current 30 Days	60 Days	90 Days	3 to 6 Months	6 months to One Year	Over One Year	Remarks
Totals Brot Forward	69,139.55	55,084.88	8,190.94	169.80	15.30	4,790.60	888.03	
Mansfield Co	24.88	24.88						Pd 1/12/25
Marlund Mfg Co	55.18	55.18						" 1/27/25
Mason Davis & Co	103.79	103.79						" 1/7/25
Marshall Estate	8.50		8.50					" 1/16/25
National Machine Co	232.00	232.00						" 1/15/25
Purple Light & Coke Co	17.50	17.50						" 1/16/25
Ramera Iron Works	35.00	35.00						" 1/16/25
Royal Textile Mills	30.00	30.00						" 1/16/25
Roxwell Oil Products Co	236.00		236.00					" 1/6/25
Rubber Restoring Co	59.21	59.21						" 1/18/25
St. John Coke & Iron Co	4,931.50					4,931.50		note
Ignatow Stoker Co	173.00	173.00						" 1/3/25
South Side Commissioners	281.80		281.80					" 1/27/25
Standard Petroleum Products	702.00	702.00						" 1/27/25
Starkey & Co. A. P.	69.75	69.75						" 1/13/25
Simkin, Mrs. H. A.	27.33			27.33				
Utley Cement Co	3,200.00	3,200.00						" 1/27/25
Van Der Water Co	59.50	59.50						" 1/8/25
Victor & Jones Co	6.00	6.00						" 1/7/25
Washington-Crowell Co	87.50	87.50						" 1/12/25
Weil & Lavin	55.10	55.10						" 1/16/25
Williams Bridge Co	69.50	69.50						" 2/24/25
Wisconsin Steel Co	42.00	42.00						" 3/24/25
Young Steel Pipe Works	70,375.71	27,046.38	16,147.99	27,181.34				" 3/24/25
" " "	6,674.00	6,674.00						" 3/24/25
Totals	156,706.30	93,827.17	24,866.23	27,388.47	15.30	9,722.10	888.03	
Contra: Inland Foundries Inc	586.45							
" Illinois Castings Co	97.78							
" " "	9,388.00	Charged off to Bad Debt						

E.4

Johnson Bros and Company
Schedule of Accounts Receivable Individuals
at December 31, 1924

Bowen, Harry A	14 24	
Burton, Thomas H.	4 178 92	
Klester, Ben. G.	3 22	
Johnson Jr. Albert L.	23 28	
Johnson, Jr. Albert L.	82 09	
Johnson, Henry C.	11 11	
Service Raymond E.	1 70	
Schwartz, Charles D.	10 40	
	4 324 94	
Johnson, Edward (credit balance)	3 23	
Balance as per Balance Sheet		$ 4 321 71
Purchases for accommodations per Balance Sheet		21 86
Henry L. Johnson (Special acct)		$ 90 000 00

Johnson Bros. and Company
Schedule of Inventories on Hand
at December 31, 1924

Work in Process			
Materials	$ 7,209.56		
Direct Labor	5,704.92		
Manufacturing Overhead	6,734.63	$	
		$	19,649.11
Raw Materials			10,866.15
		$	30,515.26

E6

Johnson Bros and Company
Schedule of Insurance Premiums paid During 1924.

Date	Voucher No		Items	Totals
1/2/24	J.245	Unexpired Premiums 1/1/24	$ 3464	
1/31/24	P-344		510 97	
2/29/24	P-352		2400	
7/31/24	P-391		2504	$ 6046 65
2/20/24	C-2	Premium refund	960	
3/6/24	C 3	" "	4320	
7/31/24	C-7	" "	2400	
12/31/24	J-276	Unexpired Insurance	1146	8826
				$ 5163 39

Unexpired Insurance

London Assurance Co #693536 4-6-27-1925	$ 2400 00	$	1200
Building on Water St #2500.00			
Fidelity & Casualty Co # 332-229-12-31-1925	10390		3463
Fidelity & Casualty Co # 122-520-12-31-1925	2500		934
Safe Burglary			
Total Unexpired Insurance 12/31/24		$	5597
Unexpired Insurance per Ledger 12/31/24			5542
Difference not adjusted			55

E1

Johnson Bros. and Company
Schedule of Taxes Paid for the Year 1924

Date	Voucher No.	Description	Items	Totals
5/31/24	P-377-63811	Franchise Tax	50.00	
7/31/24	P-392-64122	Capital Stock Tax	1293.00	
		Capital Stock & Franchise Tax for year 1924		$1343.00
		Prepaid Items at Dec. 31, 1923		
1/2/24	J 245	License for Packard Truck (1924)	$150.00	
"		Ford Truck - 1924 state	12.00	162.00
1/31/24	P 344-63147	Clydesdale truck license (1924 state)	75.00	
	63115	Vehicle License for Ford 1924	5.00	
		" " Packard "	30.00	120.00
	P-352-63251	" " Clydesdale "	30.00	30.00
				$312.00
		The above items were charged to Vouchers Payable in 1924 since they were vouched and recorded as Prepaid at 12/31/23		
		Real Estate and Personal Property Tax		
		Real Estate taxes accrued for 1923	10180.71	
		Personal Property taxes " "	696.60	
			10877.31	
		Actual R.E. and personal property taxes paid for 1923 in year 1924	14213.71	
		Difference charged to Real & Personal Property Tax expense account (See J.E. 4 for correction)		3336.40
		Real and personal property taxes accrued for the year 1924 on the basis of 1923 taxes paid.		14213.71
				$17550.11

Since the franchise and capital stock taxes paid cover the period from 7/1/24 to 6/30/25 one-half of $1343.00 or $671.50 should be set up as a prepaid tax at December 31, 1924. See J.E. 13 for adjustment

Johnson Bros and Company

Schedule of Depreciation - Cragen Plant Buildings

Years 1922 to 1924 inclusive

	Asset Value	Rate of Depreciation		Depreciation 1922	Depreciation 1923	Depreciation 1924
Balance Jan. 1, 1922	$ 235176.63	Annual Rate	1½%	$ 3527.74	3527.64	3527.64
Additions - Year 1922	12.14	Yearly Addition	3/4%	–	.19	.19
Balance Jan. 1, 1923	$ 235188.77					
Additions - Year 1923	12692.65				95.19	190.39
Balance Jan. 1, 1924	$ 247881.42					
Additions - Year 1924	none					
Balance Jan. 1, 1925	$ 247881.42					
Additions - 1925	none					
Balance Jan. 1, 1926	$ 247881.42					
Yearly Depreciation Expense				3527.74	3623.02	3718.22
Accrued Depreciation Reserve December 31				4645.42	11,074.44	15,792.66

E.9

Johnson Bros and Company
Analysis of Additions to Crosset Office Bldg.
at December 31, 1924

Date	Voucher No.	Description		
		Balance per ledger, Jan. 1, 1924		$ 51,872.77
		Additions:		
5/31/24	V-63853	Window Bobby Eng Co (one oil burner)	75.00	
6/30/24	63950	Ill Steel Co (Office Partitions)	37.48	
7/31/24	J-263	Labor Installing Oil Burner	32.53	
8/5/24	J-264	Labor & Material building oil tank	196.35	
8/31/24	V-64150	Accessory for oil burner	51	
	64181	Bushings for " "	3.03	
	64198	Balance paid on above burner	545.00	
	64202	Electric wire sockets fuses etc.	134.25	
	64205	Rewired Iron Works	1.530	1,029.45
				$ 52,912.22
		Deductions:		
7/17/24	J-262	Eliminating charges above	149.55	
9/30/24	P-22	Material for oil burner adj.	37.48	187.03
		Balance per ledger and Balance Sheet Dec. 31, 1924		$ 52,725.19

E10

Johnson Bros and Company

Schedule of Depreciation - Crozier Office Building

Years 1922 to 1924 Inclusive

		Asset Value	Depreciation 1922	Depreciation 1923	Depreciation 1924
Depreciation Rate,	Balance 1/1/22	$ 5017861	75267	75267	75267
Annual 1½%	Additions - 1922	428886	3217	644	644
Yearly additions 3/4%	Balance 1/1/23	$ 5060747			
	Additions - 1923	136530		948	1898
	Balance 1/1/24	5187277			
	Additions - 1924	85242			639
	Balance 12/31/24	$ 5272519			
Yearly Depreciation Expense			78484	76859	78448
Balance Accrued in Reserve for Depreciation, December 31			149357	226216	304664

Depreciation for year 1924 charged as per books was $7487.48, whereas the correct amount should be 7844.48. See J.E. 2 for adjustment of $36.00

Johnson Bros. and Company
Schedule of Deferred Charges
at December 31, 1924

Date	Voucher No.	Description	Details	Totals
9/30/24	P. 407	64379 - Cont'l Belt & Iron Co (Belt & Fittings)	$ 132.82	
		- 64380 Great Lakes Supply Co (cable clips)	2.64	
		64381 - Ill. Steel Co (Steel)	63.66	$ 199.12
10/31/24	P. 415	64413 Great Lakes Supply Co	75	
		64420 Scully Steel & Iron Co	19.06	
		64510 - Frank A. Donnelly Co (Board Roof)	700.00	
		64533 - Scully Steel & Iron Co.	9.53	
		64535 South Side Metal Works	324.00	
		64557 - " " " "	141.35	1,194.69
11/15/24	J. 271	Material & Labor on New Roof		160.43
11/30/24	P. 423	64638 F. A. Donnelly Co (Board Roof)	740.00	
		64645 - Chandler & Rose Steel Co	24.19	
		64667 - Henry C Kinney	440.00	
		64680 - South Side Metal Works	570.50	
		64716 - Service Roofing Co	3,182.00	11,616.69
12/31/24	P. 431	64882 - " " "		1,000.00
				$ 21,918.93
		Deduct		
11/30/24	P. 151	Old roof sold as Scrap		142.28
		Total as per Balance Sheet		$ 21,776.65

The above amount represents the cost of installing new roofs on the buildings and has been deferred due to the 1 year guarantee thereon.

The improvement was made so late in the year that no depreciation on it is claimed for 1924.

Beginning with 1925 the cost should be charged off at not less than 10% per year as the life of this type of roof is estimated to be not more than 10 years. The roof replaced one put on one of the buildings in 1917 or 1918 which lasted only about 7 years. No part of this cost should be charged against the Depreciation Reserve because this Reserve built up at 1½% per year provides only for inevitable depreciation and is not in any sense a replacement reserve because of the very low annual rate.

C. L. L.

Johnson Bros and Company

Analysis of Additions to Machinery & Equip. Account for Year Ended December 31, 1924

Date	Voucher No.	Description			
		Balance per Ledger, Jan. 1, 1924			$ 378316 29
		Additions:			
3/15/24	J-251	Allowance for old generator & Insurance as part of the cost of the new generator	1500 00		
3/31/24	J-252	Labor charges on pipe bending machine	137 81		
3/31/24	V-63458	Bristol model #332 Pyrometer	106 50		
4/1/24	J-254	Labor charges on Boiler drill	109 07		
4/30/24	V-63658	Drawer for shop equipment	9 81		
"	V-63677	100 K.W. Bullock Generator #16244	6500 00		
"	V-63699-1	Industrial Locomotive Crane Type B-3	11940 00		
6/17/24	J-261	Labor on foundation for Power Hammer	111 31		
6/30/24	V-63856	Freight paid on Power Hammer	25 27		
6/30/24	V-63949	Bolting for new Power Hammer	22 18		
6/30/24	" 63976	1-250# Mayer Power Hammer	1285 00		
7/17/24	J-262	Labor remodeling Box Car	532 63		
"	J- "	Material " " " "	179 75		
7/31/24	V-63992	Bolts for power Hammer installation	6 93		
"	V-64025	Channel for " " "	4 31		
"	" 64042	Lumber " " " "	57 68		
"	" 64044	Paint " " " "	10 44		
"	" 64053	Electrical Supplies " "	12 19		
"	" 64057	Lumber " " "	26 40		
"	" 64062	Crushed stone " " "	20 73		
"	" 64077	2 #12 Springs for " Hammer	18 00		
"	" 64079	1-10 H.P. Compensator	205 00		
"	" 64085	Freight on Air Compressor	3 50		
8/31/24	" 64175	Misc. Items for installation	6 74		
"	" 64179	1-Steel Box Car for Compressor	1500 00		
"	" 64189	Lumber for installation	15 22		
"	" 64205	Iron for installation	1 98		
"	" 64243	Painting and Preparing Steel Box Car	73 46		
9/30/24	" 64330	Steel for hoisting engine	2 44		
"	" 64357	" " " "	25 48		
"	" 64370	1-#288 1/4 Engine #45574	3800 00		
10/31/24	J-269	Labor & Material making repairs	274 15		
10/31/24	J- "	Material for pipe bending machine	10 45		
"	V-64491	Scully Steel & Iron Co - steel	4 88		
"	" 64420	" " " " "	21 62		
11/30/24	" 64671	1-#23 Prentice Vise	56 25	21407 21	
				399723 50	
		Deductions:			
3/15/24	J-251	Eliminating cost of old generator sold	1227 09		
12/31/24	J-274	Adjustment - one Steam Hammer sold	490 00	1717 09	
		Balance per Ledger and Balance Sheet Dec. 31, 1924			$ 398006 41

E 13

Johnson Bros. and Company
Schedule of Reserve for Depreciation - Machinery and Equipment at December 31, 1924

		Dr	Cr	
Balance Jan. 1, 1922				$ 156,609.25
Asset Sold - Year 1922		140.00		
Depreciation " 1922			14,471.10	
" " 1923			14,903.16	
" " 1924			15,526.45	
Assets Sold " 1924		858.96		
" " " 1924		323.20		
		$ 1,322.16	$ 44,900.71	
			1,322.16	
Net Increase 1/1/22 to 12/31/24				43,668.55
Balance per Ledger, Dec. 31, 1924				$ 200,177.80
Deduct:				
Adjustment for Excessive Depreciation (See #7)			(D)	2,727.39
Balance per Balance Sheet, Dec. 31, 1924				$ 197,450.41

E 13a

Johnson Bros. and Company
Schedule of Machinery and Equipment on Hand for Sale at December 31, 1924

Balance per Ledger, Jan. 1, 1924				$ 11,360.48
Deduct:				
5/5/24 J-258 - 2 Ass Compressors sold		726.57		
5/20/24 J-259 - 1 Punch Sold		130.49		
5/21/24 C-5 - 1 " "		225.00		1,082.06
Balance per Ledger December 31, 1924				$ 10,278.42
Auditor's Adjustments:				
(D1) - J.E. #1 To correct entry on sale of roll benders		$ 130.00		
(D2) - J.E. #12 To write off balance of account		8,978.42		$ 10,278.42

Johnson Bros and Company

Schedule of Depreciation on Machinery & Cradgew Plant

Years 1922 - 1924

Yearly Depreciation Additions		Rate - 4% - 2%	Cost	Depreciation Reserve 12/31/21	Net Value 12/31/21	Depreciation 1922	Depreciation 1923	Depreciation 1924
Additions	1893		23449	23449				
"	1894		2889 98	2889 88	(99 90)			
"	1895		99 25069	99 25069				
"	1896		3410 43	3410 43				
"	1897		967 87	948 60	19 37	19 37		
"	1898		10259 67	9644 10	615 57	410 37	205 20	
"	1899		4851 05	4365 94	485 11	194 04	194 04	97 03
"	1900		9312 21	8008 51	1303 70	372 49	372 49	372 49
"	1901		11336 87	9296 25	2040 62	453 48	453 48	453 48
"	1902		3070 31	2394 83	675 48	122 81	122 81	122 81
"	1903		10680 88	7903 87	2777 01	427 24	427 24	427 24
"	1904		20505 59	14353 90	6151 69	820 22	820 22	820 22
"	1905		2714 44	1791 35	922 79	108 57	108 57	108 57
"	1906		14631 78	9071 70	5560 08	585 27	585 27	585 27
"	1907		10583 95	6138 70	4445 25	423 36	423 36	423 36
"	1908		6389 42	3450 30	2939 12	255 58	255 58	255 58
"	1909		21400 57	10700 28	10700 29	856 02	856 02	856 02
"	1910		8402 03	3864 93	4537 10	336 08	336 08	336 08
"	1911		9043 29	3798 18	5245 11	361 73	361 73	361 73
"	1912		2813 02	1068 95	1744 07	112 52	112 52	112 52
"	1913		1591 87	541 22	1050 65	63 67	63 67	63 67
"	1914		8871 67	2661 51	6210 16	354 87	354 87	354 87
"	1915		21946 49	5706 09	16240 40	877 86	877 86	877 86
"	1916		13201 67	2904 38	10297 29	528 07	528 07	528 07
"	1917		9331 27	1679 63	7651 64	373 25	373 25	373 25
"	1918		14227 17	1991 81	12235 36	569 09	569 09	569 09
"	1919		49729 03	4972 90	44756 13	1989 16	1989 16	1989 16
"	1920		29387 00	1763 22	27623 78	1175 48	1175 48	1175 48
			224904 04	24904 04	199127 87			
Adjustment due to Obsolence			49844 52	(23376 84)	(16467 68)	(993 78)	(993 78)	(993 78)
Balance Jan 1, 1921			351189 89	191529 70	159660 19			
Additions	1922		14345 02			286 90	573 80	572 81
			371057 71					
Deduct. Assets sold		$ 55000						
Adjustments		3665 58	4215 58					
Balance Jan 1, 1923			366842 13					
Additions	1923		11474 16				229 48	458 96
Balance Jan 1, 1924			$ 378316 29					
Additions 1924			21407 21					428 14
			399723 50					
Deduct: Assets sold			1717 09					
Balance Dec 31, 1924			398006 41					
Total Yearly Depreciation						10158 02	12443 64	12799 06
Debits to Reserve for Depreciation				(28147 85)		(140 00)		(1192 16)
Accrued Depreciation Reserve				163381 85		173399 87	185843 51	197450 41

Johnson Bros. and Company

Analysis of Additions and Deductions from Motor Truck a/c for year ended December 31, 1924.

Balance per ledger, Jan. 1, 1924				$ 13 880 56
Additions:				
1/31/24 - V-63117 - 1 Clydesdale Truck 65 HP		$ 202500		
1/4/24 J-246 " "		180000		
Total Cost		$ 382500		
3/1/24 - J-250 Allowance on old Ford (showed it added to cost of new labor)		17700		
" V-63423 - 1 Ford Chassis & Equip		410 08		
Total Cost		$ 587 08		
4/30/24 - V-63633 - Lines for above new Ford Truck		68 50		
Total Additions				4480 58
				$ 18 361 14
Deductions:				
1/4/24 - J-246 - 1 Federal Truck cost $ 4013 50 less 10%				
" " 1 " " - " 3136 35 " "		$ 7 149 85		
3/1/24 J-250 - 1 Ford " " $ 465.00 less 10%		465 00		7 614 85
Balance as per General Ledger, Dec. 31, 1924				$ 10 746 29
Adjustment:				
One Packard truck purchased in 1919 for $ 6190 71 is fully depreciated: hence charged to Reserve for Depreciation by our J.E. 3				6 190 71
Balance as per Balance Sheet Dec. 31, 1924				$ 4 555 58
Analysed as follows:				
1 - U.S. Trailer Chassis purchased 1922		7500		
1 - Clydesdale Truck " 1924		382500		
1 - Ford Truck " 1924		65558		
		$ 455 58		

E15

Johnson Bros and Company
Schedule of Depreciation - Trucks
Year 1924

Items	Cost	Depreciation Taken	Net Value 1/1/24	Depreciation
Depreciation Rate 25%				
Yearly Additions - Monthly				
1 - Packard Truck	$ 6190.71	$ 6190.71		
1 - U S Trailer	75.00	28.13	$ 46.87	$ 18.75
1 - Clydesdale Truck	3825.00	none	3825.00	956.25
1 - Ford Truck	655.58	none	655.58	136.58
Total	$ 10746.29			
Less Completely depreciated 1919	6190.71			
Balance Dec 31, 1924	$ 4555.58			
Yearly Depreciation Charge				$ 1111.58
Debits to Reserve Account				(6190.71)
Accrued Depreciation Reserve		$ 6218.86		1139.71

Johnson Bros. and Company

Analysis of Additions and Deductions of Office Furniture and Fixtures for year ended December 31, 1924.

Balance per Ledger, Jan. 1, 1924			$ 10,581.68
Additions:			
2/29/24	Y-63318 - Building partitions on Office	85.00	
3/31/24	" 63405 1 - Remington Typewriter SC 33121	67.25	
"	" 63467 - Equipment for new office partitions	107.41	
4/1/24	J 255 - Additional cost of Remington Typer	35.25	
"	J 256 " " " "	45.75	
4/30/24	Y-63569 - 2 Remington Typewriters SU-DVLP 410552, SU C-LP 49227	169.25	
"	" 63595. Electrical fixtures for office	66.19	
"	" 63651. #5307 Kardex Cabinet Complete	48.00	
5/31/24	" 63814 - Cabinets for Engr. dept.	127.50	
6/30/24	63928 - Mahogany Chair	50.00	
8/31/24	" 64135 Brass Grill (Office Partitions)	36.85	
9/10/24	J-266 allowance on old Elliott Fisher mach. part cost of new machine	202.00	
9/30/24	Y-64277 - Freight on Elliott Fisher mach.	10.26	
10/31/24	Y 64459 } 1 - Elliott Fisher Check writer, 1 " " Posting Machine	347.00	
11/30/24	" 64662 - 1 #5307 Kardex Tele Cabinet	48.00	
"	" 64697. 4 #4138-1 Stamper Cased	16.00	
12/31/24	" 64782 - 2 #1942 Revolving Chairs	48.00	2,274.71
			$ 12,858.39
Deductions:			
4/1/24	J 255 - 1 Typewriter sold	97.50	
"	J 256 1 " "	97.50	
9/10/24	J 266 - Elliott Fisher Machine traded in	539.00	734.00
	Balance per Ledger Dec 31, 1924		$ 12,124.39

Johnson Bros. and Company
Schedule of Reserve for Depreciation - Office Furniture and Fixtures, December 31, 1924

		Dr	Cr	
Balance per ledger Jan. 1, 1922				4761 94
Depreciation - year 1922			944 57	
" " 1923			980 02	
Adjustments due to Sales "		80 75		
" " " " "		107 25		
Depreciation - year 1924			1171 33	
Adjustments due to Sales 1924		97 50		
" " " " "		97 50		
" " " " "		26 95		
Totals		$ 409 95	$ 3095 92	
			409 95	
Net Increase				2685 97
Balance per ledger, Dec. 31, 1924				$ 7447 91
Adjustments:				
Balance in Reserve per ledger 1/1/22		4761 94		
" " Reserve per Schedule E 17a		4658 36	103 58	
Depreciation per books.				
1922	$ 944 57			
1923	980 02	1924 59		
Depreciation Adjusted per Schedule E 17a				
1922	721 05			
1923	774 33	1495 38		
Excessive depreciation 1922 - 1923			429 21	
Depreciation per Books 1924		1171 33		
" per Schedule E 17a		920 33		
Adjustment of Depreciation 1924			251 10	
Total Adjustment per J. E. # 6				783 89
Adjusted Balance in Reserve for Depreciation (Schedule E 17a) as per Balance Sheet, Dec. 31, 1924				6664 02

E 17a

Johnson Bros and Company
Analysis of Depreciation - Office Furniture & Fixtures

Yearly Depreciation - Rate 10% 5%		Book Value	Reserve for Depreciation 12/31/21	Net Value of Additions 12/31/21	1922	1923	1924
Additions	1911	$ 2072.77	2072.77	—			
"	1912	324.87	308.64	16.23	16.23		
"	1913	37.09	31.53	5.56	3.71	1.85	
"	1914	152.15	114.13	38.02	15.22	15.22	7.58
"	1915	346.16	225.01	121.15	34.62	34.62	34.62
"	1916	1013.49	557.42	456.07	101.35	101.35	101.35
"	1917	1769.71	796.36	973.35	176.97	176.97	176.97
"	1918	573.60	200.75	372.85	57.36	57.36	57.36
"	1919	168.70	42.17	126.53	16.87	16.87	16.87
"	1920	1746.89	262.04	1484.85	174.69	174.69	174.69
"	1921	950.70	47.54	903.16	95.07	95.07	95.07
Balance January 1,	1922	$ 9156.13	$ 4658.36	4497.77			
Additions	1922	579.18			28.96	57.91	57.91
Balance Jan 1, 1923		$ 9735.31					
Additions 1923		1324.40				61.22	122.44
		$ 10959.71					
Deduction - Assets Sold		376.03				(18.80)	(37.60)
Balance January 1,	1924	$ 10583.68					
Additions	1924	2274.71					113.74
		$ 12858.39					
Deduction - Assets Sold		734.00					(77)
Balance per Balance Sheet 12/31/24		$ 12124.39					
The following assets are fully depreciated							
	1911	2072.77					
	1912	324.87					
	1913	37.09					
	1914	152.15					
		$ 2586.88					
Total Yearly Depreciation as above					721.05	774.33	920.23
Debits to Reserve for Depreciation						(188.00)	(221.95)
Accrued Depreciation Reserve			4658.36		5379.41	5965.74	6664.02

The above analysis of depreciation abstracted from Revenue Agent's Report and was found to be correct. Adjustments are shown in schedule E17 and journal entry #

H.J.

Johnson Bros. and Company
Analysis of Lunchroom Equipment Additions
for year ended Dec. 31, 1924

Balance per ledger, Jan. 1, 1924	705.87
Additions:	
9/31/24 - V - 63782 - 1 Doz Water tumblers	22.5
Balance per ledger and Balance Sheet Dec. 31, 1924	708.12

John

Schedule of

		Asset Value
Balance, Jan. 1, 1922	$	5026.
Additions - Year 1922		1259
Balance, Jan. 1, 1923	$	6286.
Additions - 1923		772
Balance Jan. 1, 1924	$	7058.
Additions 1924		32
Balance Jan. 1, 1925	$	708

Yearly Depreciation

Accrued Depreciati

Johnson Bros. and Company
Schedule of Vouchers Payable
at December 31, 1924

Name	Voucher No	Amount
Chicago Sports Assoc	64900	$ 150.00
Elgin, Joliet & Easton R.R.	1	18.00
Illinois National Bank	2	115.89
Acme Gas Co	3	9.75
American Foundries Inc.	4	157.56
Baker & Company	5	161.25
Black Cutlery Co	6	3.84
Chicago Hydrogen Co	7	78.54
" " "	8	196.02
Chicago Association of Commerce	9	1.50
" Tool Co	10	1.02
" Towel Co	1	27.00
Crane Plumbing Co	2	.22
Dahlen, James A	3	15.00
Eagle Carborundum Co	4	30.64
Eddy Foundry Co	5	51.60
Fedora Co	6	3.57
Detroit Lead Co.	7	1443.17
Freeman and Fiske	8	35.02
Furman Steel Co	9	31.88
Geiger, Geo	20	5.00
Great Lakes Supplies Inc	1	45.17
Hedge Coal Co	2	192.28
Hudson Steel Foundry Co	3	171.60
Hughes & Co	4	387.25
Hush a Phone Corp	5	10.00
Ill. Bell Tel. Co.	6	76.33
Ill. Manufacturers' Assoc.	7	50.00
Illinois Steel Co	8	106.64
Illinois Supply Co	9	46.00
Jones & Son, Chas	20	8.15
Johnstone, Alfred	1	5.95
Klehm, George	2	382.62
Kelly Foundry & Mach Co.	3	24.00
Kewanee Boiler Co.	4	22.93
Lovett & Co.	5	40.74
Leavitt Bros	6	37.65
National Mach. Co.	7	7.08
Chicago Coal Co	8	31.70
Peoples Coal & Coke Co	9	256.69
Optimum Refining Co	40	766.20
Boston Battery Corp	1	100.77
Riverside Iron Works	2	305.83
Roswell Oil Corp	3	243.28
Smith Bros. Plumbing Co.	4	4.25
Smith Iron Works	5	43.50
Stevens Stationery Co	6	5.70
Sunley Corp.	7	57.91
System Sire Co.	8	11.98
Valley Steel & Tool Co.	9	11.98
Wallace Bros	50	.25
Western Union Tel. Co.	1	5.64
Youngstown Steel Co	2	6.03
Inland Steel Co.	3	54.68
Totals Vouchers Payable		$ 6454.36

Johnson Bros. and Company
Accrued Wages and Salaries
at December 31, 1924

Payroll.			
Dec 27, 29, 30 and 31 - detailed J 275			
credited to a/c # 2104		$	4408.83

Johnson Bros and Company
Schedule of Accrued Taxes
at December 31, 1924

Real Estate & Personal Property Taxes accrued on the taxes of 1923 Taxes payd				$	14213 71
Itemized as follows.					
Personal Property taxes for year 1923					
Vol. 49 Item 3338			$	632 80	
R E Taxes for 1923 Vol. 231 Item 957				893 83	
" " " " 231 " 17				593 25	
" " " " 231 " 15				635 55	
" " " " 379 " 266				5741 28	14213 71

Johnson Bros and Company
Schedule of Liability Insurance for year 1924

2/29/24 P-352 63260 Premium Paid on Policy	$ 2387.20		
5/31/24 - P-376 63718 Premium on Erection	930.53		
12/31/24 - J 276. Accrued Dec 31, 1924	4491.81		
		$	7809.54
5/29/24 Cash refund of overpayment			590.23
Total Public Liability Insurance Expense 12/31/24		$	7219.31

2/29/24. P-352 Premium paid on policies	$ 106.00		
5/31/24 - P-376 63718 . on Erection	82.51		
12/31/24 - J-276 Accrued 12/31/24	463.56		
Total Public Liability Ins Expense 12-31-24		$	652.07

12/31/24 Accrued Employees Liability Insurance	$ 4491.81		
Accrued Public Liability	463.56		
Total Accrued Liability Ins 12/31/24		$	4955.37

Johnson Bros and Company
Schedule of Rates Used on Employees Liability & Public Liability Insurance - Year 1924

	Pay Roll	Rate	Insurance
ESTIMATED LIABILITY INSURANCE			
Manufacturing Boiler Shop	$ 100000.00	2.00	2000.00
Machine Shop		1.10	
Erection in Illinois	5000.00	2.72	136.00
" Indiana		2.80	
Clerical Office	20000.00	.04	8.00
Chauffeurs & Helpers	7500.00	1.12	84.00
Blast Furnace Erection - Ill	1000.00	5.32	53.20
" Ind		5.28	
" " Ill		2.52	
Masonry Work		2.50	
Iron & Steel Erection - Ill	1000.00	5.32	53.20
" " " Ind.	1000.00	5.28	52.80
Tank Building Metal Erecting Ill		2.72	
Inside Exclusively		2.80	
Total Advance Premium			$ 2387.20
Actual Employees Liability			
Boiler Shop	1274723.53	2.00	2549.47
Machine Shop	46608.15	1.10	512.69
Erecting Missouri	445.00	none	
" Indiana	6711.54	5.28	354.37
" Illinois	12332.76	2.72	335.45
" Indiana	2339.35	2.80	65.50
Clerical	2544184	.04	1018
Chauffeurs	2393.93	1.12	38.01
Erection Ill.	13189.76	2.52	332.38
" Indiana	5077.69	5.28	268.096
			$ 6879.01
Actual Public Liability			
Boiler Shop	1274723.53	.05	637.4
Machine Shop	46608.15	.02	9.32
Erecting Illinois	12332.76	.55	67.83
" "	13189.76	.45	59.35
" Indiana	2339.35	.55	12.87
" "	5077.69	.55	27.927
" "	6711.54	1.15	77.18
Total Public Liability Insurance			564.56
Total Liability Insurance			$ 7448.57
Deduct Amt of Premium paid Amt Paid on Public	2387.20 / 166.00		2493.20
Amount Due on Liability Insurance as per Ledger & Balance Sheet 12-31-24			$ 4955.37

Johnson Bros and Company
Schedule of Reserve for Land Value Adjustment
at December 31, 1924

11/10/22 Balance	$	11,166.92
3/19/24 Cash (Consideration for perpetual easement privileges account of underground conduit system of Chicago Sanitary District		500.00
Balance as per Ledger & Balance Sheet 12/31/24	$	11,666.92

Johnson Bros. and Company
Analysis of Surplus Account
Jan 1, 1924 to Dec 31, 1924

1/1/24 Balance per Auditor's Report			$ 1216907.57
Deduct.			
3/14/24 - J 252 Dividend #89 - 60%	$ 600000.00		
3/3/24 P. 361 1923 Income Tax Paid	8835.29		
6/20/24 385 1919 Additional Income and Excess Profits Tax	20336.56		
9/24/24 J 267 Dividend #90 - 40%	400000.00		129171.85
Balance per Ledger December 31, 1924			$ 1087735.72
Auditors Adjustments			
Additions.			
J.E 8 To restore as a claim for refund the amt taken as a claim for credit against the unpaid portion of the 1920 tax	8250.15		
J.E 9 - To increase claim from amount originally claimed to amount finally allowed	14.80		
J.E 13 - To set up one half of franchise and capital stock taxes paid in 1924 for period 7/1/24 to 6/30/25	671.56		9063.45
			$ 1096799.17
J.E 6 Excess depreciation office furniture			632.79
			1097331.96
Deductions.			
J.E 1 - To correct entry of June 1, 1923 on sale of soil binders	$ 1300.00		
J.E 4 - Real Estate tax paid in excess of the amount accrued at 12/31/23	3336.40		
J.E 10 - To adjust accounts for payment of income tax June 9, 1924	2291.71		
J.E 12 Balance on Machinery and Equip on Hand for Sale Account written off	8978.42		15906.53
Adjusted Balance Dec 31, 1924			$ 1081425.43
Add: Net Profit for Year 1924 (Exhibit II)			167193.00
Surplus per Balance Sheet Dec 31, 1924			$ 1248618.43
Analysis of Dividends.			
Fred Johnson	$ 333000.00		
Edwald "	333000.00		
William "	333000.00		
Chas E. Sowers	10000.00		
	$ 1000000.00		

F1

Johnson Bros. and Company
Schedule of Loss or Gain on Fixed Properties Sold During year 1924

Description of Asset	When Acquired	Cost When Purchased	Depreciation Taken	Net Value	Selling Price Value Received	Loss - * or Gain
Generator - Electric	1906	1227.09	858.96	368.13	150.00	218.13 *
Federal Truck 3 Ton	1919	4013.50	4013.50	None	900.00	900.00
" " 2-Ton	1919	3136.50	3136.50	None	900.00	900.00
Ford Truck	1922	465.00	174.37	290.63	177.00	113.63 *
Underwod Typewriter		97.50	97.50	None	25.00	25.00
" "		97.50	97.50	None	35.00	35.00
Single frame Steel Hammer	1906	490.00	333.20	156.80	25.35	131.45 *
Elliott Fisher Machine	1923	539.00	62.88	476.12	202.00	274.12 *
Totals		$ 10,065.74	$ 8,774.26	$ 1,291.68	$ 2,414.35	$ 1,122.67

(F2)

Johnson Bros. and Company

Schedule of Machinery Sold from the Obsolete Machinery & Equip. on Hand for Sale - Year 1924

	Salvage Value	Selling Price by Value Recd.	Loss or Gain
Steam Air Compressor #10	1000		
" " " #20	716.57	1282.20	598.37*
#1 - Punch	355.49	225.00	130.49*
Totals	$ 1082.06	352.20	$ 728.86*
Net Gain			29.381
Net Gain on Sale of Capital Assets per Schedule		$ 1226.7	
Net Loss on Sale of Obsolete Machinery as above		$ 729.86	
		$ 29.381	

F3

Johnson Bros. and Company
Schedule of Executive Salaries at Dec. 31, 1924

Name	Duties	Time Devoted	Stock Held	Compensation
Fred Johnson	President	Entire	333	$ 12000.00
Edward "	Vice Pres.	"	333	12000.00
William "	Treas.	"	333	12000.00
Chas C. Sowers	Secretary	"	1	6500.00
			1000	$ 42500.00

Johnson Bros. and Company
Schedule of Donations
Year of 1924

1/31/24	To Marlmann - Xmas		6.00
12/31/24	Field Day Contributions		10.00
12/31/24	Xmas Gifts to Employees	2,372	00
"	" " " "		67.00
		$ 2,355	00

Johnson Bros. and Company
Schedule of Bad Debts Charged Off
in the Year 1924

12/31/24 - Inland Steel Co $ 938.00

Resolution in Minute Book
Dated 12/22/24

The merchandise represented by the above amount was manufactured presumably for the Inland Steel Co. on their purchase order although the material was made for certain individuals who were operating a separate company and they purchased this item on the credit of the Inland Steel Co.
To avoid a case of probable hard feeling between the Inland Steel Co. and Johnson Bros. and Company, the latter decided to write it off.

Johnson Bros. and Company
Schedule of Bad Debts Recovered During the Year 1924

6/30/24	J-262	Edward H. Schwartz	$ 25.00
7/31/24	C-7	" " "	50.00
			$ 75.00

The above amount was charged off as a bad debt 12/31/23

Johnson Bros and Company
Schedule of Work Completed by Jocelyn and Moore

Outline of Work	Name	Date
1. Payroll checks drawn on the Illinois Savings Bank checked against the payroll book for the months of January, April and August.	S.J.	2/5/25
2. Checked cash receipts from deposit book to bank statement and to the detailed cash book and to the control cash book Totals were checked into ledger Footings were tested - Jan to Sept	G.M.	2/5-2/6/25
3. Checked cash disbursements checks to detailed cash book and totals to control cash book. Totals checked to ledger. Outstanding checks were checked against list on back of bank statement. Footings of control cash book were tested Jan to Sept. 1924 - November & December checks were checked into detail cash book and to control cash book	G.M.	2/7-2/8/25
4. All checks outstanding Dec. 31, 1924 on General Account were verified and found correct	G.M.	
5. Checked the distribution of vouchers in the voucher register and tested footings Jan to June - Aug. Oct and Dec	G.M.	
6. Accounts Receivable - Customers added trial balance and prepared schedule of Ageing of accounts. 1st check - footings and postings	G.M.	2/9/25
7. Analyzed and scheduled all additions and deductions to fixed properties	S.J.	2/6-2/8/25
8. Scheduled the loss and gain from the sale of fixed assets. Checked all the sales and found them correct	S.J.	2/5/25
9. Trial Balance of general ledger entered on working trial balance.		

Johnson Bros. and Company
Schedule of Work Completed by Joslyn and Moore

Outline of Work	Name	Date
Ledger account footings and postings were tested	G. M.	2/5/25
10. Federal Tax Claims analyzed and adjustments made	S. J.	2/8/25
11. Inventories tested as to footings and extensions - Valuations in Work in Process tested with cost records	G. M.	2/9/25
12. Prepaid and accrued items verified and scheduled	G. M.	2/10/25
13. Analyses of Reserves for Depreciation and Depreciation detailed	S. J.	2/7/25
14. Tests of expense accounts and schedules of insurance and taxes paid, including liability insurance - executive salaries donations, bad debts	S. J.	2/9/25
15. Adjusting Journal Entries	S. J.	2/10/25
16. Completion of Working Trial Balance	S. J	2/10/25
17. Examination of minutes, and other important papers	S. J	2/10/25
18. Journal and other books of original entry examined and footings and entries tested	G. M.	2/9/25
19. Analysis of Surplus	S. J.	2/10/25
20. Draft of Balance Sheet, Operating statements and comparative statements	S. J. & G. M.	2/11/25
21. Draft of Report	S. J	2/12/25

A

A
PE

I
E
U