Volume 48 | Issue 5 Article 8

11-1929

Students' Department

H. P. Baumann

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H. P. Baumann, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

[Note.—The fact that these answers appear in The Journal of Accountancy should not cause the reader to assume that they are the official answers of the board of examiners. They represent merely the opinions of the editor of the *Students' Department.*]

Examination in Auditing

May 16, 1929, 9 A. M. to 12:30 P. M.

The candidate must answer all the following questions:

No. 1 (5 points):
Define—
(a) Subsidiary corporation.
(b) Investment-trust corporation.
(c) Holding company.
(d) Close corporation.
(e) Affiliated company.

Answer:

With the exception of (b) investment-trust corporation, the following are tentative definitions submitted by the special committee on terminology of the American Institute of Accountants and published in The Journal of Accountancy (January, 1929):

(a) Subsidiary corporation:

"A company, the voting stock of which is fully owned, or nearly so, by another company, to which the first company is a subsidiary. To qualify as a subsidiary company for the purpose of rendering consolidated income-tax statements it is necessary that the control be firmly fixed in the hands of the controlling company, intercompany stock ownership, ownership by the same individuals and some other considerations being given weight. Reference to the latest tax regulations and decisions is recommended as the rules are subject to periodical revision."

(b) Investment-trust corporation:

An organization of investors using their combined funds for the purpose of purchasing, under scientific management, a wide variety of securities; due regard being given to safety of principal through diversification, regularity of income, and probable appreciation in market values, with no intention of gaining a controlling interest in any company whose securities it owns, and with the sole purpose of investing for the benefit of the shareholders.

(c) Holding company:

"A company, the principal business of which is to hold the stock of one or more other companies. A holding company may also be directly engaged in business on its own account, but in so far as it is a 'holding company' its business does not include active operations. Some holding companies control the operations of some or all of the companies whose stocks they hold; some take no part in controlling the operations of other companies but act as investors only."

(d) Close corporation:

"A corporation the stock of which is held in few hands and not freely sold. The restraint on sale may be provided in the by-laws of the corporation, by definite contract between the stockholders, or by a general understanding among them. In most close corporations the restraint is a 'gentlemen's agreement.'"

(e) Affiliated company:

"A company which by reason of stock ownership is permanently controlled by another company; the name indicates that the company is the 'child' of the 'parent,' or controlling company. It is not necessary that the entire issue of the company's stock should be owned by the controlling company."

No. 2 (12 points):

State in detail how you would audit the accounts of an investment-trust corporation.

Answer:

Before the date set for the count of the securities, the agreements, charter, etc., under which the investment trust is operating should be examined to determine what class of securities may be purchased, what discretionary powers are granted in the purchase and sale of securities, and what other important powers may be given to the management. A schedule should also be prepared from the securities ledger showing stock or bond number, description, par value, if any, or amount, where deposited, cost, market price, interest earned, dividends received, etc. Certificates should be obtained from depositories holding securities for safekeeping, delivery or collateral as of the balance-sheet date.

If possible, the cash, negotiable instruments and securities on hand or in vaults should be inspected and counted at the close of business on the balance-sheet date, and, in any event, should be kept under control until all have been verified to prevent substitution. The securities should be checked against the schedule which has previously been prepared.

The bank accounts should then be reconciled.

Purchase confirmations and brokers' sales slips should be checked against the purchase and sales registers, the dates and prices being especially noted. The prices should be compared with official price lists, and commission and interest computations should be tested.

Footings, cross footings, and postings of the various records should be proven and checked.

The securities schedule should be checked with that prepared for the previous audit, and securities no longer owned should be traced through the cash-receipts book to the bank statement to account for their disposal.

Securities are generally shown at cost. If written up to a market price, the off-setting credit must be made to a special surplus account.

The dividend and interest record should be checked against the official list of dividends declared and interest paid.

The fixed-asset accounts should be analyzed with attention to the propriety of charges and the adequacy of reserves for depreciation.

Prepaid expenses should be checked, and accruals and other liabilities verified and confirmed.

Secure confirmation from the trustee of the amount of bonds authorized and outstanding, and from the registrar or transfer agent or both of the amount of each class of capital stock authorized and outstanding.

No. 3 (10 points):

A dispute has arisen between the A corporation and its creditors as to its solvency and prospects, and you are called in as an advisor.

What statements would you submit, and how would you use them to convince both sides as to the advisability (a) of continuing the business, or (b) of liquidating the corporation?

Answer:

The accountant should prepare a comparative balance-sheet, a comparative statement of profit and loss for the past three years or more, and a statement of affairs with the relative deficiency account. Upon the bases of the data contained in these statements, the accountant could decide upon the advisability of continuing or liquidating the business.

The comparative balance-sheet should show the financial condition of the business on a "going value" basis at a recent and a past date. A study of the changes in the various assets and liabilities should disclose the trend toward an improved or worse condition.

The comparative profit-and-loss statement should show the results of operations for the current and past periods. A study of the changes in sales, cost of sales, and detailed expenses should be made to ascertain the trend of operating results.

The statement of affairs should show the assets, pledged or unpledged, at both the book and liquidating values, the liabilities in the order of rank, and the estimated loss, if any, to the creditors upon liquidation. The deficiency account should show the estimated loss or gain on the realization of the assets.

No. 4 (6 points):

State how you would proceed to verify the property and plant accounts of a company which has never been audited before.

Answer:

The procedure would depend upon the purpose and scope of the audit, the number and amounts of the transactions to be verified, and whether the property and plant accounts were valued at cost, appraised or other values.

If appraised values are to be used, and if the property has been appraised at a recent date, it is necessary only to verify the additions since the date of the appraisal. If the property is to be or has been appraised as of the date of the balance-sheet, the entries for capital and revenue charges should be examined for the period under audit for the purpose of determining that the profits are correctly stated.

If the property is valued at cost it would be necessary to analyze the property accounts from the inception of the business to determine:

1st. That the accounts have been classified in sufficient detail to permit charging into separate accounts the various elements of property which differ in nature.

2nd. That charges for repairs, replacements or renewals have not been included in the asset accounts.

3rd. That the value of any property or plant abandoned had been credited to the accounts at the values originally charged thereto.

4th. That no depreciation or obsolescence has been credited to the asset accounts.

It is not necessary to make an exhaustive verification of all charges to the accounts but only comprehensive tests of the principal items. In many cases it is customary to examine the entries in the property accounts for the audited period only, even though there has been and is to be no appraisal. This is true, particularly, when the company has been in existence for a long time and a complete examination of the property accounts would be a laborious task. But in such cases the auditor should qualify his report to indicate the limitations of his examination.

The auditor should examine all papers dealing with the purchase of the property such as deeds, abstracts of title, guarantee policies, contracts, vouchers for payments, etc. He should also determine whether the property is clear of incumbrances, and should indicate that it is not if such should prove to be the case. If any part of the fixed assets is constructed by the client, the charges for materials, labor and other costs should be verified to determine, principally, that no profit on the cost of construction has been included.

Theoretically the title to the property should be determined to be in the name of the company, and it is suggested that the insurance policies and the minutes of the meetings of the board of directors be examined.

The auditor should satisfy himself that the reserves for depreciation are adequate.

No. 5 (10 points):

The M company has outstanding its entire capital stock of one hundred thousand shares, $25 par, on which $12.50 per share has been paid in, the balance remaining subject to call at the discretion of the directors. Since the business has proved highly profitable and a surplus of three times the capital stock has been accumulated, the directors wish to make the capital stock full-paid. Your advice is asked as to the best method of carrying out this purpose, with care for the financial interests of both the company and its stockholders. What would you advise? Give reasons.

Answer:

The outstanding capital stock of one hundred thousand shares, $25 par, can be made fully paid by the declaration and payment of a dividend of $1,250,000 payable in the subscriptions receivable of that amount. By following this method, the company would (1) relieve the stockholders of their liability to the company, (2) strengthen the credit position of the company because of the capitalization of that portion of the earned surplus charged as dividends paid, and (3) maintain the working-capital position of the company. The dividend, however, is subject to surtax payable by those individual stockholders whose income, including their share of the dividend, is subject to such tax.

The tax liability may be avoided and the aforementioned results may be obtained as follows:

The capital structure should be changed from one hundred thousand shares of $25 par stock to two hundred thousand shares of $12.50 par stock. The outstanding stock should be called in, the subscriptions canceled and one hundred thousand shares of $12.50 par stock issued in lieu thereof. A stock dividend of the remaining one hundred thousand shares of $12.50 par stock should then be declared and paid.

The choice of the method to be followed would depend somewhat on the number of stockholders, the distribution of the stock, and the cost and other factors involved in changing the capital set-up and exchanging the capital stock.

No. 6 (9 points):
(a) Name the factors in determining an amount of depreciation.
(b) State to what extent each factor is ascertainable by the auditor.

Answer:

(a) The amount of depreciation depends upon:

(1) The cost of the asset, including the cost of installation.

(2) The salvage or residual value, if any, of the asset at the end of its useful life.

(3) The useful life of the asset.

(b) The cost of the asset, including the cost of installation, etc., can be readily ascertained by the auditor by an examination of the records.

The salvage value and the useful life of the asset can not be definitely determined by the auditor as these factors are estimates only.

The auditor must depend upon his own and the company's past experience with similar assets, reports of engineers, reference books, etc., to check the adequacy of the depreciation charge which is based upon these estimates and the factor of the cost of the asset.

No. 7 (15 points):

Prepare in detail a programme for the examination of the financial condition at a given date of either (a) a stock-brokerage firm or (b) a commercial bank.

Answer:

(a) Stock-brokerage firm:

On the balance-sheet date start the audit as soon as possible after the entries for the day have been recorded in order to obtain the "position" of customers' accounts, securities and bank loans.

From the cashier's records obtain—

1. A detailed list of securities on hand in the company's collateral boxes (margined securities).
2. A detailed list of securities on hand in the company's safekeeping boxes (customers' securities).
3. A detailed list of bank and other loans together with lists of collateral therefor.
4. A detailed list of securities which are out for transfer.
5. A detailed list of securities due to brokers (charged out but not delivered).
6. A detailed list of securities due from brokers (charged in but not received).
7. A detailed list of securities ordered out from correspondent brokers but not yet received.

From the margin clerk's records draw off, on separate sheets, customers' debit or credit balances and list thereon the securities which each customer is "long" or "short," as well as securities wholly owned by the customers and held in safekeeping.

From the customers' ledgers draw off, on separate sheets, customers' debit and credit balances and list the securities which each customer is "long" or "short."

From the master security record draw off, by security names, lists of customers "long" or "short" those securities; and the location of the securities—on hand, at brokers, in banks, etc.

Prepare and send out confirmations for

1. Bank loans and collateral.
2. Securities out for transfer.
3. Securities due to and owed by the brokerage firm.
4. Customers' accounts (if possible have duplicate copies of customers' statements prepared for the auditor's files so that any differences referred to later by the customers in reply to the request for confirmation may be checked against this duplicate copy).

Count cash on hand.

Count securities in the boxes, customers' and safekeeping, using the lists prepared as a guide.

Reconcile the bank accounts.

Check the customers' positions as shown by the master control, margin record and ledger accounts against each other and reconcile the differences.

Check the securities on hand, in banks, at brokers and out for transfer against the master securities record and reconcile differences.

Value the securities using correct market quotations as of the audit date in order to check the adequacy of the margin accounts, the margin of security held by the banks and the relationship between the customers' margin accounts and securities held.

Verify any other current assets with regard to value.

Analyze fixed-asset accounts with attention to the propriety of charges and the adequacy of the reserves for depreciation.

Check prepaid expenses, verify and confirm accruals and other liabilities.

(b) A commercial bank:

Count all cash.

Inspect and list all stock and bond security holdings.

Inspect and list all time and demand notes held and verify, by correspondence if practicable.

Inspect and list all securities held as collateral.

NOTE.—All cash and negotiable instruments should be held under control until all are counted and examined to prevent duplication or substitution.

Inspect clearing-house items and obtain verifications from the clearing house to detect unpaid items.

Reconcile correspondents' accounts including the federal reserve bank and rediscounts.

Determine that the detail of depositors' accounts, certified cheques and certificates of deposit are in agreement with the respective controlling accounts.

Verify the collection of income on securities owned.

Determine the adequacy of the provision for unearned discount on loans.

Verify the outstanding capital stock.

Verify the expenses.

Analyze fixed-asset accounts to determine the propriety of charges and the adequacy of reserves for depreciation.

Check prepaid expenses, verify and confirm accruals and other liabilities.

No. 8 (15 points):

The accompanying statement is submitted to you by the company whose books you are to audit. You find that the figures are in accordance with the books, and are arithmetically correct.

A B CORPORATION

Balance-sheet, December 31, 1928

Assets

Cash	$ 14,374.51
Liberty bonds	10,961.55
Accounts and notes receivable (less reserve)	143,499.51
Investments in other companies	127,787.63
Cash value of life insurance	6,030.45
Inventories	253,167.50
Fixed assets (less depreciation)	911,200.22
Patents	1.00
Prepaid items	9,749.20
Reserve for depreciation	58,604.04
Reserve for bond interest	29,168.75
	$1,564,544.36

Liabilities

Notes and accounts payable	$ 152,672.45
Accrued items	19,368.69
Mortgage bonds	460,000.00
Class A stock	792,425.00
Surplus	43,927.29
Gain for the period before depreciation and bond interest	96,150.93
	$1,564,544.36

Profit-and-loss statement for the year ended December 31, 1928

Sales (net)		$1,284,149.45
Deduct:		
Cost of goods sold—		
Materials used	$463,101.41	
Manufacturing expense (before bond interest and depreciation)	437,513.60	900,615.01
Gross profits on sales		$ 383,534.44
Deduct:		
Selling expenses	$265,838.00	
General administrative expenses	112,154.75	377,992.75
		$ 5,541.69
Other income:		
Purchase discount	$ 568.70	
Interest received	650.55	
Recovered on items previously charged off	431.15	
Gain on stock purchases	32,125.00	
Income from subsidiary companies	57,309.29	91,084.69
		$ 96,626.38
Other charges:		
Interest paid	$ 331.27	
Tax refunds to bondholders	144.18	475.45
Gain for the period before depreciation and bond interest		$ 96,150.93

Give a brief report of your assumed findings with comments on unusual or important items and prepare a statement showing how the accounts should be presented, with a certificate such as you would feel justified in giving.

While you are expected to imagine the conditions on which you comment they must not be inconsistent with the figures.

Answer:

(Date)

Board of Directors,
A B Corporation,
Chicago, Illinois.

GENTLEMEN:

We have examined the books and accounts of The A B Corporation, Chicago, Illinois, and, as a result of our examination, have prepared the accompanying balance-sheet and operating statements.

The cash, liberty bonds and notes receivable were verified by inspection, certificates obtained from the depositories, or other satisfactory evidence of ownership. The accounts receivable were verified from the company's records and examined for collectability. Sufficient reserves have been provided for probable bad-debt losses.

The inventories were verified by us as to extensions, footings and pricings, but no verification was made of quantities. We were furnished with a certificate from responsible officers of the company which stated that the quantities had been determined by physical count, weight or measure and that the inventory was valued at cost or market, whichever was lower.

The cash-surrender value of the insurance policies on the lives of officers was verified by an examination of the policies.

It will be noted that a segregation has been made of the prepaid items as shown in the statement prepared by your accountant. We found this item to consist of prepaid insurance and unamortized bond discount in the amounts shown in the accompanying balance-sheet. These prepaid expenses were verified, and we ascertained that the bond discount is being amortized over the life of the bonds.

The investments in other companies were written up during the year from cost, $70,478.34, to $127,787.63. This write-up was credited to income from subsidiaries and represented, we were informed, the A B Corporation's share of the earnings in the other companies. Since we were unable to verify the financial conditions of the other companies, we have shown the investments at cost.

Depreciation on fixed assets in the amount of $291,875.30 had been credited directly to the asset accounts on your books. On the basis of our examination of those accounts, we recommend that the accompanying journal entry (6) be made to reflect the assets on the books at cost and to set up the reserves for depreciation.

Accounts and notes payable were verified in so far as possible by comparison with creditors' statements and by correspondence with the holders of the notes.

The first-mortgage six per cent. bonds and the amount of the accrued bond interest were verified by correspondence with the trustee.

By authority of the secretary of state the company, on July 31, 1928, retired the entire amount of its class "B" capital stock and changed the name of the class "A" stock to "common." The class "B" stock was, on retirement, purchased at a discount of $32,125, which has been credited by us to capital surplus.

It is recommended that the accompanying adjusting journal entries be entered on the books of the company, as of December 31, 1928, to bring the books into agreement with the financial statements.

Yours very truly,

(Signed) ——— ———,
Certified Public Accountants.

A B Corporation

Adjusting journal entries December 31, 1928

(1)		
Notes receivable	$ 23,500.00	
Accounts receivable		$ 23,500.00
To separate the notes receivable from the accounts receivable.		
(2)		
Accounts receivable	2,199.09	
Reserve for bad debts		2,199.09
To set up reserve for bad debts which has been deducted from accounts receivable.		
(3)		
Raw-materials inventory	158,794.69	
Work-in-process inventory	35,769.25	
Finished-goods inventory	58,603.56	
Inventories		253,167.50
To separate the inventories as of December 31, 1928, into their respective accounts.		
(4)		
Prepaid insurance premiums	336.70	
Unamortized bond discount	9,412.50	
Prepaid items		9,749.20
To separate the prepaid items into individual accounts.		
(5)		
Income from subsidiary companies	57,309.29	
Investments in other companies		57,309.29
To write down the investment account to cost value.		
(6)		
Land	45,000.00	
Buildings	214,144.00	
Machinery and equipment	934,495.27	
Office equipment	9,436.25	
Depreciation	58,604.04	
Reserve for depreciation		58,604.04

Reserve for depreciation—buildings..........		22,944.00
Reserve for depreciation—machinery and equipment..............................		266,998.65
Reserve for depreciation—office equipment....		1,932.65
Fixed assets............................		911,200.22
To set up fixed-asset accounts at cost, to write off depreciation for the current year, and to set up reserve-for-depreciation accounts.		
(7)		
Bond interest..............................	27,600.00	
Bond discount amortized.....................	1,568.75	
Reserve for bond interest..................		29,168.75
To write off bond interest and discount incorrectly charged to reserve for bond interest.		
(8)		
Accounts payable..........................	10,000.00	
Notes payable...........................		10,000.00
To segregate accounts and notes payable.		
(9)		
Accrued items............................	19,368.69	
Accrued bond interest....................		13,800.00
Accrued expenses.........................		5,568.69
To classify accrued items of expense.		
(10)		
Gain on stock purchases....................	32,125.00	
Capital surplus—discount on purchase of class "B" stock retired......................		32,125.00
To set up capital surplus for gain on stock purchased at a discount.		

NOTE.—Many of the amounts used in the above entries were not given in the problem, but are assumed amounts which might result from the breakdown of certain accounts that were given. Considerable leeway is given the candidate to draw upon his imagination in assuming the conditions behind the statements submitted in the problem. For this reason the above explanatory journal entries are presented, although not a particular requirement of the problem.

It is assumed that an analysis of the materials-used account showed it to consist of the following:

	Debits		Credits
Purchases...............	$421,684.41	Inventories 12/31/28	$253,167.50
Inventory of raw materials 1/1/28...............	190,085.03		
Inventory of finished goods 1/1/28...............	63,225.79		
Inventory of work in process 1/1/28............	41,273.68		
Balance $463,101.41			

A B CORPORATION

Balance-sheet—December 31, 1928

Assets

Current assets:				
Cash		$14,374.51		
Liberty bonds (at cost)		10,961.55		
Accounts receivable—trade	$122,198.60			
Notes receivable—trade	23,500.00			
Total	$145,698.60			
Less: reserve for losses	2,199.09	143,499.51		
Inventories—				
Raw materials	$158,794.69			
Work in process	35,769.25			
Finished goods	58,603.56	253,167.50	$422,003.07	
Cash-surrender value of life insurance			6,030.45	
Prepaid insurance premiums			336.70	
Unamortized bond discount			9,412.50	
Investments in other companies)at cost)			70,478.34	

Fixed assets:

	Cost	Reserve for depreciation	Book value	
Land	$ 45,000.00		$ 45,000.00	
Buildings	214,144.00	$22,944.00	191,200.00	
Machinery and equipment	934,495.27	266,998.65	667,496.62	
Office equipment	9,436.25	1,932.65	7,503.60	
Totals	$1,203,075.52	$291,875.30		911,200.22
Patents				1.00
				$1,419,462.28

Liabilities and net worth

Current liabilities:			
Accounts payable		$142,672.45	
Notes payable		10,000.00	
Accrued bond interest		13,800.00	
Accrued expenses		5,568.69	$ 172,041.14
First-mortgage bonds, 6%, due January 1, 1935			460,000.00
Net worth:			
Capital stock—			
Common—			
Authorized—40,000 shares of a par value of $25 each	$1,000,000.00		
Unissued	207,575.00	$792,425.00	
Surplus—			
Balance, January 1, 1928	$ 43,927.29		
Less: loss for year ended December 31, 1928	81,056.15	37,128.86*	
Capital surplus—discount on purchase of class "B" common stock retired		32,125.00	787,421.14
			$1,419,462.28

We have examined the accounts of the A B CORPORATION, Chicago, Illinois, for the year ended December 31, 1928, and, subject to the correctness of the quantities of merchandise included in the inventories, we hereby certify that, in our opinion, the attached balance-sheet and operating statements correctly set forth respectively, the financial position of the company as at December 31, 1928, and the results from operations for the year ended that date.

(Signed) ——— ———,
Certified Public Accountants.

A B CORPORATION

Reconciliation of net profit for the year ended December 31, 1928

Profit per books	$ 96,150.93
Loss as adjusted	81,056.15
Difference	$177,207.08
Accounted for as follows:	
Depreciation for year ended December 31, 1928	$ 58,604.04
Bond interest for year ended December 31, 1928	27,600.00
Bond discount amortized	1,568.75
Discount on purchase of class "B" common stock retired erroneously included in profits	32,125.00
Write up of investments in other companies erroneously included in profits	57,309.29
Total	$177,207.08

A B CORPORATION

Statement of profit and loss for the year ended December 31, 1928

Sales:		
Gross sales	$1,297,567.74	
Less: returns and allowances	13,418.29	
Net sales		$1,284,149.45
Cost of goods sold		958,719.05
Gross profit on sales		$ 325,430.40
Selling and general expenses:		
Selling expense	$ 265,838.00	
General administrative expense	112,654.75	378,492.75
Net loss from operations		$ 53,062.35
Other income:		
Discount on purchases	$ 568.70	
Interest received	650.55	
Recoveries on bad debts	431.15	1,650.40
Net loss from operations and other income		$ 51,411.95
Other expense:		
Bond interest paid	$ 27,600.00	
Bond discount amortized	1,568.75	
Other interest paid	331.27	
Tax refunds to bondholders	144.18	29,644.20
Net loss for year		$ 81,056.15

A B CORPORATION

Statement of cost of goods manufactured and sold for the year ended December 31, 1928

Raw materials:		
Inventory, January 1, 1928	$190,085.03	
Purchases	421,684.41	
Total	$611,769.44	
Inventory, December 31, 1928	158,794.69	
Cost of raw materials used		$452,974.75
Labor		316,488.33
Manufacturing expenses:		
Factory expense	$121,025.27	
Depreciation	58,104.04	179,129.31
Total manufacturing cost		$948,592.39
Add: decrease in inventory of work in process:		
Inventory, January 1, 1928	$ 41,273.68	
Inventory, December 31, 1928	35,769.25	5,504.43
Cost of goods manufactured		$954,096.82
Add: decrease in inventory of finished goods:		
Inventory, January 1, 1928	$ 63,225.79	
Inventory, December 31, 1928	58,603.56	4,622.23
Cost of goods sold		$958,719.05

No. 9 (10 points):

A, the administrator of the estate of B, deceased, finds that B had a business of which he was the sole owner, and also that B was a partner in another business. The court directs A to continue the solely owned business for the present.

(a) What accounts should A keep for these two assets?

(b) State briefly how these accounts should be kept.

Answer:

The books of both the partnership and sole proprietorship should be closed as of the day of B's death and the value of B's interests should be recorded on the books of A, the administrator of the estate of B, by debiting "Interest in B & Company" and "Interest in B–C partnership" and crediting "Estate principal."

Upon the settlement of B's interest in the partnership, cash (notes receivable, etc.) should be debited with the proceeds and "Interest in B–C partnership" credited. After the last liquidating dividend has been received and entered the balance in "Interest in B–C partnership" account would represent a gain or loss and should be transferred to either "Gain on realization" or "Loss on realization."

The accounts on the books of the sole proprietorship which were closed as of the day of B's death, may be reopened to record the transactions of the business which is to be continued "for the present" by A. The proceeds of the liquidation of this business should be accounted for in the same manner as was suggested for the interest in the partnership. Any income resulting from the operations of the business under A should be credited to "Income from interest in B & Company."

No. 10 (8 points):

What criticisms have you to make of each of the following certificates?

(a) We have audited the accounts of the A B Company for the year ended December 31, 1928, and we certify that the foregoing statement of receipts and disbursements is in accordance with the books of account.

(b) We have audited the books and accounts of the A B Corporation and of its subsidiaries, the D E Company, and the firm of F & G, for the year ended December 31, 1928, and we hereby certify that, in our opinion, the accompanying consolidated balance-sheet and consolidated statement of income and profit and loss correctly exhibit respectively the financial position of the A B Corporation and its subsidiaries at December 31, 1928, and the results of operation for the year ended at that date.

(c) We have audited the books and accounts of the A B Corporation for the year ended December 31, 1928, have examined the related records of original entry and supporting documents, including monthly reports received from its branches and subsidiaries, and we hereby certify that the accompanying consolidated balance-sheet and consolidated profit-and-loss account correctly exhibit the consolidated financial condition of the companies and their consolidated income results for the year.

(d) (At the foot of the statement) "Audited and found correct."

Answer:

A general criticism may be made of all the above certificates in that they are not signed, contain no date, and do not include, with the exception of (b), the phrase "in our opinion."

(a) This certificate is too indefinite. All that is definitely known about the statement of receipts and disbursements is that it is in accordance with the books. While it is stated that the accounts of the A B Company were audited it can not be determined that the receipts and disbursements from which the statement was prepared are correct. A balance-sheet audit, only, may have been made, the scope of which would not include an audit of the receipts and disbursements.

(b) This certificate includes as a subsidiary of the A B Corporation, the firm of F and G, which as the designation "firm" denotes, is a partnership. It is rather unusual to find a set of circumstances under which the accounts of a partnership may be consolidated with those of a corporation or corporations, for relatively very few corporations are expressly authorized by their charters to become partners. It may be possible, in this case, that the A B Corporation and the D E Corporation have such authority, and are partners of the firm of F and G. In such circumstances, the certificate given can not be adversely criticized, except possibly in its reference to the firm of F and G as a subsidiary of the A B Corporation.

(c) While the books and accounts of the branches and subsidiaries of the A B Corporation were not audited the system of internal check, the control by the A B Corporation through the monthly reports, the nature of the business, and the character and amount of the assets and liabilities of the branches and subsidiaries may be such as to warrant the certification of the consolidated balance-sheet and the consolidated profit-and-loss account. It is suggested, however, that the phrase "in our opinion" be included.

(d) It is questionable whether this may be called a certificate. It is entirely too brief.