1-1-1934

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PREPARATION OF BALANCE SHEETS FOR AUDIT

A Discussion Presented at the Binghamton Chapter of the National Association of Cost Accountants

NOVEMBER 22, 1934

BY

VICTOR H. STEMPF
of Touche, Niven & Co., New York, N. Y.

"A review of the pre-audit work which may be done by industrial accountants to expedite the examination undertaken by public accountants."

Touche, Niven & Co.
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The program chairman of your Chapter in assigning this subject had something more in mind than a general airing of sound accounting principles. It implies a review of the pre-audit work which may be done by industrial accountants to expedite the examination undertaken by public accountants.

We need not demonstrate the fact that today the trained accountant, in whatever capacity he may be serving, is recognized as a worthy servant of management. He has justified his cost, but that cost must be kept within due bounds. If the cost of an audit exceeds its utility it must be brought into line, and if the comptroller is not doing everything possible to expedite the work of the auditors he is not rightly serving his organization.

Human relationships, whether those of man and wife, employer and employee—or, more pointedly, the relationship between management and the comptroller, or between comptroller and auditor—may take one of three courses,—viz: dominance, compromise, or cooperation. Any self-respecting man, who recognizes a responsibility to himself and to others, finds dominance intolerable. It is incompatible with the democratic thought of our country and stupidly futile, inasmuch as it feeds a smoldering fire of disloyalty which ultimately will break into flame. While compromise serves a purpose it, at best, represents a temporary concession. Cooperation alone affords a solution to all problems of human relationship. Team work is of vital importance in the relationship between management and the comptroller on the one hand and the public accountant on the other. Mutual respect, courtesy and cooperation are not only ethical ideals but sound working tools in business. There is a classical anecdote about Lincoln which points a moral: He was riding with a friend one morning, when passing an old darky who doffed his hat; Lincoln
did likewise. Lincoln's friend scoffingly remarked: "Have you no self-respect, lifting your hat to a nigger?"; to which Lincoln replied: "Would you have me be less courteous than a negro?"

We need not walk around the block seeking darkies to whom to tip our hats, but we can all respect the finer sensibilities of others without risking imposition. The habitual "hard-boiled" or hyper-critical attitude is often adopted to disguise an inferiority complex.

Before discussing the directions which team-work between the comptroller and public accountant may take, let us consider the objective of an audit. That objective is to obtain confirmation of the fairness of the financial statements of the company.

**THE PURPOSE AND LIMITATION OF FINANCIAL AUDITS**

Early in 1933, the New York Stock Exchange conducted an inquiry into the character and scope of audits performed by public accountants in respect of the published financial statements of listed companies. Incident to that inquiry a group of nine accounting firms, responsible for the audits of most of the listed companies, joined in a communication to the Exchange reading in part as follows:

"We fully recognize the importance of defining the responsibility of auditors and of bringing about a proper understanding on the part of the investing public of the scope and significance of financial audits, to the end that their importance should not be underrated nor their protective value exaggerated in the minds of investors. This is the more necessary because the problem of delimiting the scope of examinations is essentially one of appraising the risks against which safeguards are desirable in comparison with the costs of providing such safeguards. The problem is to develop a general scheme of examination under which reasonably adequate safeguards may be secured at a cost that will be within the limits of a prudent economy."

The communication proceeds to discuss the character of verification suggested in the Federal Reserve Bulletin (with which you are probably familiar) entitled: "Verification of Financial Statements", and points out that the bulletin recognizes that an
effective system of internal control would make unnecessary some portions of the procedure therein outlined. Naturally, the larger a corporation and the more extensive and effective its system of accounting and internal check, the less extensive need the detailed checking be to assure an adequate verification of the balance sheet. However, the examinations made by independent auditors, coupled with the system of internal control, afford as effective a safeguard as is obtained by more detailed checking where less adequate internal check exists. Primarily, companies rely upon internal check to prevent or disclose defalcations, and independent accountants making a financial examination do not attempt to duplicate the work of internal auditors and, therefore, do not assume responsibility for the detection of defalcations, unless the terms of the arrangement with the client affirmatively contemplate the type of detailed examination which will enable the accountant to assume that responsibility. (The Auditor’s tests of Internal Control will be referred to later.)

In the letter to the Exchange, previously referred to, the following statement was also made:

“We think it well to emphasize the fact that financial statements must necessarily be largely expressions of judgment and that the primary responsibility for forming these judgments must rest on the management of the corporation. And though the auditor must assume the duty of expressing his dissent through a qualification in his report, or otherwise, if the conclusions reached by the management are, in his opinion, manifestly unsound, he does not undertake in practice, and should not, we think, be expected to substitute his judgment for that of the management when the difference is not of major importance, when the management’s judgment is not unreasonable and when he has no reason to question its good faith.”

The auditor’s judgment in respect of published financial statements should be based upon the consistent application of sound accounting principles (having substantial authority back of them) to the evaluation of the facts in a given case. Consistency of
accounting practice from year to year is a prime essential in stating the financial position and results of operations of an enterprise. The emphasis today from the investors' standpoint is not so much upon asset values as upon the earning power of the assets. In other words, emphasis has shifted from the balance sheet to the statement of operations. Vital changes in practices such as revising the fundamental bases of valuation of inventories, shifting depreciation rates or altering methods of calculating unrealized profits will have a material effect upon the determination of income and upon the valuation of assets. Changes will, at times, be fully justified, but, if made, must be clearly revealed.

Professor T. H. Sanders, our National Past President, who served as research secretary to the Committee on Statistical Reporting and Uniform Accounting for Industry, of the Advisory and Planning Council for the Department of Commerce, prepared a report for that Committee promulgated under date of August 2, 1934, in which he says:

"The symmetry and balance of published statements have led to a popular impression that the figures contained in them are matters of final and undisputed fact to a greater degree than is warranted by circumstances. The impression is sometimes held, moreover, that these statements, in addition to showing the past, can and should show what is going to happen to the company within the immediate future. Neither of these assumptions can be fulfilled in practice."

"A business is a living, moving thing. In the course of its operations it is constantly transforming its assets from one stage to another and is constantly gaining or losing ground in the process. . . . To regard every amount appearing on these statements as an indisputable fact is to attribute to the statements a greater degree of certainty than they possess."

A rather extraordinary acknowledgment of the limitation of financial statements appeared in the report of Mr. Earle Bailie, Chairman of the Board of the Tri-Continental Corporation, dated April 17, 1933, which accompanied the published financial statements of that Corporation as at March 31, 1933, as follows:
"There are certain matters regarding the income account which we would call to your attention. In recent years, changes in conditions and in the laws affecting the payment of dividends have resulted in a very substantial change in the nature of dividends.

Today, dividends may no longer be assumed to represent distributions of current income. Under the existing laws of many states, dividends may be paid out of excess of assets over legal capital and liabilities, whether such excess is the result of accumulation of income or of purely capital transactions. Even interest payments, under certain circumstances, may not represent income to the recipient.

We have given much consideration to the question of how far, in such circumstances, dividends, interest payments, and other items should be brought into the income account. After consultation with counsel and auditors we have, however, been unable to find any satisfactory rule by which we can be governed in including or excluding certain items from the income account, which can be regarded as based on accepted practice or which would be likely to be generally understood by investors. We have, therefore, with the concurrence of our counsel and auditors, determined to continue for the present to include in income all cash dividends, interest payments and service fees, except those expressly declared or stated to be liquidating distributions. We desire, however, to make it clear to shareholders that neither all amounts shown in the income account, nor the dividends being currently paid by the corporation, are to be regarded as representing solely income."

Financial statements are largely the reflection of judgment, and accounting is, therefore, fundamentally an art and not a science. Accounting is the art of presenting financial situations, based upon the consistent application of recognized conventions to the interpretation of the facts in a given case. It is the function of the accountant to express an informed and unbiased judgment in respect of the financial statements. Hence the traditional use of the phrase "In our opinion" in all accountants' reports. From the viewpoint of the Company, the principal objective of the financial audit, therefore, is to obtain a con-
firmation of the fairness of the financial statements of the Company (after adjustment, if necessary,) before submitting the annual report to stockholders and other interested parties. (Bear in mind that the subject of this discussion does not contemplate the consideration of the various types of detailed examinations and investigations.) The financial statements are representations made by the Company, and the public accountant is called upon to express his considered opinion relative to the fairness of the statements.

To become thoroughly familiar with the latest thought on the subject, the following documents should be studied thoroughly:


Brief reference to the purposes and substance of the Securities Exchange Act and Securities Act will be made later in this discussion.

Cooperation of the Comptroller and Public Accountant

The preceding remarks are considered essential in establishing a background for the following comments which relate directly to the subject: what the comptroller may do to expedite the audit procedure.

System of internal control:

There is no one factor of more importance in curtailing the expense of an audit than an effective system of internal control.
Internal check contemplates an accounting routine under which the work of each employee is counter-checked, in detail or in total, by the work of another employee.

A complete system of counter-check presupposes an organization large enough to allow a complete departmental segregation of accounting functions. Complete control of all details, however, is rarely found even in the largest organization as the cost of safeguarding certain types of transactions may be greater than the losses which might result through the absence of such safeguard.

A comptroller has not performed the most essential function of his office unless he has established a degree of internal control commensurate with the hazards of the particular business and within the limits of the reasonable cost of providing safeguards against such hazards. An ideal routine may be prescribed, but may be worthless because it is not enforced. We must "practice what we preach." Many an organization has a beautifully bound and elaborate manual relating to prescribed internal control; some of this may never have been put into effect; much of it may have been abandoned; and probably none of it has been tested as to effectiveness, because no evidence can be presented to confirm the fact that the prescribed routine has been adhered to. The major need is that of effectiveness. It is nevertheless the task of the comptroller (perhaps with the assistance of professional advisers) to produce a manual of internal control. The basis of its preparation lies in a survey of personnel and records and in the preparation of a chart of accounts supplemented by charts of the functional divisions of the business. In other words, an inventory of employees must be taken recording in detail the character of work which each individual and each class of employee performs in the preparation, checking, recording, or approval of transactions which ultimately find their way into the books of account. These memoranda of personnel and records are the pieces of the jig-saw puzzle which must be sorted and coordinated to produce the completed picture. Bear in mind also that accounting operations often are permitted to become perfunc-
tory, and that internal control often breaks down through the improper shifting of duties, and the discontinuance of a clerical operation because adherence has never been checked and the employee does not recognize its importance.

In connection with the realignment of duties, there are a few essentials relating to personnel which should be borne in mind.

(1) The proper discharge of duties requires that each employee shall be weighed as to physical fitness, native ability, knowledge and experience requisite to handle the task assigned.

(2) Every member of the staff should be required to take a vacation at least once a year, and employees should be rotated in position, to the extent which may be practicable.

(3) Officers and employees who are responsible for cash, securities and valuable merchandise should be bonded.

(4) Access to securities should be had only by two or more officers jointly.

(5) The custodians of notes receivable and securities should take no part in keeping the general ledger accounts or accounts receivable.

(6) Notes and acceptances payable should be signed and countersigned by executives.

(7) Substantial expenditures for fixed assets should be made on specific appropriation by the proper authorities.

Furthermore, no system of internal control can be satisfactory without provision for a degree of internal auditing. Naturally, greater reliance may be placed upon the work of the internal auditing department if its operations are independent of the accounting department, i.e., the work of checking is a departmental function separate and apart from that of originally recording accounting transactions. The work of internal auditing should ordinarily include most of the following audit steps:

(a) Verification and reconciliation of bank balances.
(b) Verification of petty cash funds.
(c) Verification of branch operations and of current assets held at branch offices.
(d) Periodical confirmation of accounts receivable.
(e) Test of book inventory records by physical count.
(f) Test of the approval of vouchers before payment.
(g) Verification of cash sales.

Beyond these the functions of the internal auditors may be extended without limit to those performed by external auditors, depending upon the size of the particular business.

The result of each examination conducted by internal auditors should be reported in writing by the men conducting the examination. These reports should serve the comptroller as a basis for remedial steps, and should be retained for review by the external auditors.

In smaller businesses internal auditing may be united with the rotation of duties. Thus, one branch accountant may be assigned to audit the records of another branch accountant, and a man who has previously maintained other records, may be relieved of his present duties for the purpose of conducting an internal audit of the records which he previously maintained. The development of an internal auditing staff in a growing business will normally take form through this type of internal audit.

THE RUDIMENTS OF INTERNAL CONTROL

Cash receipts:

The routine should assure the prompt recording of all receipts in money. Cash registers or other mechanical devices should be used to record such receipts. Regular readings of registers should be compared with recorded cash receipts by an employee other than a member of the sales force or a member of the cashier's department. Cash registers should be so controlled as to assure no interference with the correct recording of sales through manipulation of the locking devices of machines or the removal of tapes. In the absence of cash registers or similar
devices, numerically controlled sales tickets should be used, and consecutive numbers should be accounted for periodically. A summarization of these tickets should be compared at regular intervals with recorded cash receipts, by an employee other than a member of the sales force or of the cashier’s department. In the event that both cash registers and sales tickets are used, the register readings and totals of sales ticket summaries should be compared with the cashier’s record by an independent employee.

Similar control should be provided in respect of collections on C. O. D. sales and in respect of cash collections received directly by cashiers in settlement of accounts receivable.

The proper control of cash received through the mail is very often lacking. The opening of the mail should be under the supervision of a responsible employee other than a member of the cashier’s department and an independent listing of cash received through the mails should be made by such employee, the details of which should subsequently be compared with the cashier’s record of receipts, in order to assure that all such receipts have been properly accounted for in the cashier’s department. Miscellaneous receipts arising from the sale of scrap, insurance claims, etc. should be reported to the comptroller independently of the report which accompanies the cash to the cashier’s department, and the comptroller should compare the details of such report with the cashier’s record of receipts.

Cash received by outside salesmen and collectors should be confirmed by notations on invoices submitted to customers or otherwise, and customers should be advised that all checks should be made payable to the order of the company and not to the order of salesmen or collectors. The checking of salesmen’s orders and collectors’ cash should be performed by employees independently of the cashier’s department.

All cash receipts should be handled and recorded by a receiving cashier who has no part in maintaining either the general ledger or accounts receivable ledgers and who has access neither to such ledgers nor to the statements sent to customers. All cash receipts should be deposited promptly and intact, and deposits should be
taken to banks by employees other than the cashier, incident to which duplicate deposit slips should be obtained or a confirmation of the amount of deposit mailed by the bank direct to the comptroller. This is particularly desirable when deposits include large amounts of currency, and will prevent shortages therein being made up by cashiers without the knowledge of the comptroller.

Deductions for cash discounts, allowances, etc. should be checked to establish the correctness thereof.

Major cash disbursements:

All major cash disbursements should be made by check so that bank accounts will furnish independent substantiation of such transactions. All checks should be numbered serially and such check numbers should be recorded in cash disbursement records. Every voided check should be retained and accounted for, and every check should be definitely related by stamp or other device to the invoice paid or to the voucher authorizing the disbursement.

A list of all checks prepared for payment should accompany the checks submitted to executives for signature, so that such executives may retain actual records of all checks signed. These lists should be retained by such executives for the use of the internal auditors in comparing the checks entered on the cash disbursement records. No one should be asked to sign a check unless there be presented to him simultaneously the invoices or underlying vouchers to which such checks relate. Particularly in respect of major disbursements provision should be made for the counter-signature of checks, and care should be exercised to see that such counter-signatures are not perfunctory. It is obvious also that blank checks should never be signed in advance. Disbursement checks should be prepared by an employee who has no part in keeping the general ledger, accounts payable ledger, or voucher record and to whom access to such records is denied.

Many defalcations have been effected by the use of improperly approved credit memoranda or adjustment slips, and similar
items for which checks have been drawn. Such disbursements should be supported by approved memoranda, and such approval should be by responsible parties outside the accounts payable department.

**Minor cash disbursements:**

Where it is necessary to make minor cash disbursements in currency, the imprest system should be used. Under this system the following controls are basic:

(a) The amount of the imprest fund should be fixed at the smallest possible amount and reports of disbursements should be made periodically.

(b) All imprest fund disbursements should be approved by responsible parties on a regular, prenumbered voucher.

(c) A receipt should be obtained for each disbursement. Petty cash vouchers should be completely prepared in ink and the amount should be written in. Petty cash vouchers and supporting invoices should be stamped with the date and number of the reimbursing check, in order to prevent subsequent re-use.

**Bank balances and cash funds:**

Balances reported by banks should be reconciled periodically with ledger balances by an employee independently of the cashier's department. Similarly, petty cash and other working funds should be counted and verified periodically by a representative of the comptroller's department.

**Accounts receivable:**

The maintenance of accounts receivable should be a separate functional sub-division of the accounting department. Bookkeepers engaged on such ledgers should have no connection with the cashier's work and, per contra, cashiers should have no access to ledgers nor to statements sent to customers.

There should be also a distinct separation between the credit department and the accounting department, and a systematic
method should be employed in the collection of accounts. Collection follow-ups should never be entirely under the control of the accounts receivable bookkeepers. Entries in control accounts should be based upon totals compiled in other departments, and accounts receivable ledgers should be balanced with controlling accounts at regular intervals, and should be checked and confirmed periodically by employees other than those who normally maintain the ledgers.

Accounts charged off as uncollectible should be supported by memoranda bearing the approval of an authorized official. Such accounts should be carried in a separate ledger and collections should be recorded therein by the accounting department and not by collectors. Periodical lists of collections should be submitted to the principal in charge of collections and the lists should be approved by him after he has compared them with his collection files.

Inventory:

Perpetual inventory records of stock on hand ordinarily afford the most satisfactory check of physical count, and provide a safeguard against losses through theft or inefficiency. Controlling accounts for stock on hand should be maintained and should record all materials received, purchased, manufactured, issued, and sold. The perpetual inventory records should be balanced periodically with general ledger control accounts. In industrial enterprises the stores' ledgers should be subjected to periodical check by physical count by persons outside the stores department. Adjustments of these records should be approved by an authorized official.

Branch offices:

Branch offices may take the form of sales units, production units, or completely independent organizations. The type of control of branch operations imposed will, therefore, depend upon the basis of operations at branches.

When branches are merely sales offices, branch expenses should be paid from an imprest fund. Reports of disburse-
ments accompanied by receipted invoices or approved vouchers should be sent to the head office for reimbursement. When branch offices operate more or less as complete units, the following items are typical of the controls to be established:

(a) A perpetual inventory of all goods shipped to or purchased by the branch should be kept at the head office.

(b) Copies of all branch sales invoices should be sent to the head office where a controlling account of the branch accounts receivable should be maintained.

(c) A trial balance of branch ledgers should be sent to the head office each month.

(d) Copies of all approved credits and journal entries should be sent to the head office for examination.

(e) Cash collections should be deposited in a local bank account over which the branch has no control. All checks on this account should be drawn by the head office.

(f) Copies of branch cash records and duplicate deposit slips should be sent to the head office.

(g) Bank statements and paid checks should be sent directly to the head office by the local bank.

(h) Properly approved disbursements for petty cash expenses should be reimbursed by the head office on the imprest fund system.

When the branch operations are too elaborate for these types of control to be sufficiently effective, it naturally follows that adequate check of the operations of such branches may be effected only through traveling auditors.

**Accounts payable:**

Accounts payable ledgers and voucher registers should be under the control of a separate unit of the accounting department. Bookkeepers engaged on such records should have no connection with the cashier's work and in turn cashiers should have no access to accounts payable records nor to statements received from creditors.
Trial balance of voucher registers and accounts payable ledgers should be agreed with controlling accounts at regular intervals by individuals other than those who regularly maintain the records. Statements received from suppliers should be reconciled monthly by representatives of the comptroller who are independent of the accounts payable or cashier's departments.

In cases where invoices are sent to various departments before entry in purchase ledgers, an invoice register or some similar record should be used as a means of tracing invoices and of determining liability for merchandise in transit or held in receiving rooms. All invoices received should be entered in the register and should be checked off when they are entered in purchase ledgers. Adjustment of accounts payable for errors or other causes should be approved by responsible employees.

Sales:

Sales should be so safeguarded as to prevent the delivery of merchandise or the performance of service without a record of the sales transaction being made. Manifold sales tickets ordinarily afford a basis for the satisfactory check of cash sales. Merchandise should be checked against cash sales figures by a second employee before the delivery of merchandise to customers, or customers should present paid sales tickets in order to receive delivery of such merchandise. Numerical control of cash sales tickets should be provided. These tickets should be verified as to prices, extensions, and totals by an employee other than a member of the sales or cashier's departments. The daily total of cash sales should be determined by such independent person.

Orders relating to charge sales should also be controlled numerically. No merchandise should be shipped other than through the medium of an accepted sales order, and no merchandise should be shipped without proper approval of credit. Quantities should be checked before shipment and sales invoices should be controlled numerically. Sales invoices should be prepared from sales orders which indicate dates of shipment and credit approval. Office copies of sales invoices should be sup-
ported by the sales orders, and should form the sales record from which customers' accounts are posted and from which the summary of sales is made for control purposes. Sales invoices should be verified as to prices, extensions, totals, discount, etc. before being transmitted to customers. Credit memoranda for returned sales and allowances should be supported by advices from the receiving department or from other independent officials indicating the quantity, description and condition of the merchandise returned or the reason for an allowance. Memoranda recording allowances and credit for merchandise returned to the sales department should be independently approved as to the allowance and as to the quantity and condition of the merchandise returned.

**Purchases and expenses:**

All purchases should be made by a delegated authority through the medium of a purchase order. Purchase orders should be numerically controlled and should be prepared in manifold for the use of the purchasing department, receiving department and the accounting department.

Purchase invoices should not be approved by an executive for payment unless the goods or services shown on the invoice are supported by a proper purchase order and are billed in accordance with the terms, prices and other conditions shown on the purchase order, and there should be an approval on the supporting document indicating that the goods have been received and are of the type, quantity and quality billed on the invoice. The supporting documents should also bear an approval indicating that all extensions, footings and other calculations of the invoice have been verified and a further approval indicating the accounts to which such purchases are to be charged.

A voucher system is ordinarily desirable as it affords a basis for relating every check issued to an audited invoice or voucher. After an invoice or voucher has been approved for payment the check number should be noted thereon in order to prevent duplicate payment.
A record of purchases returned to shippers should be kept by the shipping department. This record should be checked by a representative of the comptroller's department so as to assure the receipt of proper credit from suppliers.

Vouchers for expenses should be paid only upon the approval of an authorized official. Traveling expense vouchers should be sufficiently detailed to indicate the propriety of the charges.

Expenditures for postage, where substantial, should be protected by the use of postage meter machines and/or by reports from postmasters.

Heads of departments should approve departmental usage of postage as a check on the postage reported as consumed by mailing departments. Mailing departments should be so organized that an employee having custody of postage stamps does not have access to the records in mailing departments or other departments which establish the accountability for postage in his possession.

**Payroll:**

The functions of timekeeping, preparing payrolls, and payoffs should not be combined under the control of one employee. This work should be performed by different employees or departments and should be checked independently before payrolls are released. Ordinarily, the following controls should be provided:

(a) Payrolls should be prepared in the paymaster's department from time-clock cards or from other forms of time reports submitted by time-keepers.

(b) A labor recapitulation should be prepared in the accounting or cost department from time tickets or piece work production records.

(c) The accounting or cost department should verify the payroll prepared in the paymaster's department and reconcile such payroll with the labor recapitulation.

(d) Payrolls should be approved for payment by an official, after he has satisfied himself that the necessary internal verification of the payroll has been made.
(e) Payrolls should be paid in the presence of a witness, who should have no connection with the preparation or verification of the payroll.

In addition, certain rules should be observed in connection with payroll accounting, as follows:

(a) Payroll departments should be operated on the imprest plan so that the paymaster must account for all money in his hands at all times.

(b) Timekeeping should be based on automatic time records. If such recorders cannot be provided, daily time reports should be made by timekeepers and approved by foremen or other officials to whom employees report.

(c) No name should be added to the payroll except on formal authorization of the person responsible for employment.

(d) All rate changes should be approved by the head of the department affected.

(e) Every employee should be provided with a receipt on which the name, identification number, amount, and pay period are shown. On pay day each employee should turn in to the paymaster a receipt, with his name and address signed by him, in exchange for his pay envelope (there are, of course, infinite varieties of this type of control).

(f) Lists of unclaimed wages should be prepared and submitted to the comptroller's department. The comptroller's department should examine all receipts for amounts subsequently paid. If unclaimed wages are held intact for a time, provision should be made periodically for the return of such funds to general cash.

General:

Needless to say, there are endless ramifications of internal control beyond those suggested in the preceding outline, depending upon the particular type of business, its magnitude, and the hazards entailed. It should be reiterated that the establishment
of methods of internal control, metaphorically stated, simply represent "the bidding of the hand," whereas it is "the playing of the cards" that produces results.

**Effect upon external audit:**

Attention was previously directed to the fact that the extent of detailed verification undertaken by external auditors is definitely related to the effectiveness of internal control existing in the particular business. Therefore, it behooves the comptroller:

(a) To install effective methods of internal control,
(b) To see that such methods are adhered to, and
(c) To retain for the use of the external auditors, in the best possible form, evidence which will serve to demonstrate the effectiveness of the internal control.

These reports, or other evidences of internal audit, may serve the further purpose of expediting such tests of the system of internal check as the external auditor may deem necessary to satisfy himself that effective control does, in fact, exist. The line of authority and responsibility, the rotation of employees, the preparation and retention of internal audit reports, will necessarily have a material bearing upon the external auditor's viewpoint. Needless to say the internal audit reports should be prepared with considerable thought as to both form and substance and should bear the signature of the examiner. The examiner's working papers supporting his report should be retained for subsequent reference.

The impression should not be gathered that the work of internal auditors may be substituted for the work which the external auditor must do to satisfy himself concerning the effectiveness of internal control, but the evidence which the comptroller may adduce to support his representation that internal control is effective will have a material bearing upon the extent of the related work undertaken by the external auditor.
CASE STUDY

There is appended hereto a set of simple financial statements which may aid those who are visually minded in following a somewhat sketchy outline of the work normally performed by an external auditor and which may serve to emphasize the discussion of the related work to be undertaken by the comptroller's department in the expedition of such an examination.

Time does not permit of a full discussion of the sampling and testing of transactions performed by auditors and the following comments will be directed particularly to the balance sheet with, here and there, an incidental reference to the statement of operations.

Cash:

Custom permits the inclusion in this classification of both cash on hand and cash on deposit in banks. It is interesting to observe that at a recent meeting of the American Society of Certified Public Accountants, Dean Madden, of New York University, seriously questions the propriety of using that caption, pointing out that the recent bank holiday emphasized the fact that balances in banks do not necessarily represent available cash, and that businesses would be well advised, to use the expression appearing in the balance sheets of many of our largest banks, viz: "due from banks and bankers."

It is customary for the accountant to visit the client's office at the close of business on the last day of the fiscal period and to call for the production of all cash items, notes receivable and securities. Cash on hand includes undeposited receipts, imprest funds, unclaimed wages, and other safe-keeping funds. In connection with undeposited receipts much of the clerical detail involved in the verification of this item by external auditors may be avoided if the comptroller will arrange to have the deposit actually prepared and available for the accountants to seal or otherwise keep under control until turned over to the bank, placed in the mail, or turned over to the representative of the
armored-car service, not later than the morning of the business day following the date of the count. The comptroller should be careful to retain a special record of any checks representing transfers between banks in order that their disposition may be traced by the auditor. Similarly, undeposited receipts should be reconciled with entries in the cash book in detail and the records of such reconciliation should be made available to the auditor for re-check. The comptroller should issue instructions that all disbursement funds should be cleared of vouchers and should be reimbursed immediately at the close of business to avoid the necessity on the part of the auditor to prepare a record of unreimbursed vouchers included in such funds and to prepare the adjustments necessary to clear the accounts at the audit date. All cash on hand at branches which may not be of sufficient relative amount to warrant a personal count by a representative of the auditor should be supported by a certificate obtained by the comptroller, signed by the branch office manager, and the individual responsible for the funds. Similarly, unclaimed wages should be cleared before the close of business to such an extent as may be possible to minimize the count thereof.

The comptroller should cooperate with the external auditor to provide an adequate control of securities, notes receivable, treasury stock, or other negotiable instruments which must be scrutinized at the same time that cash is counted. If the examination of these documents must be delayed provision should be made for the sealing of vaults or the denial of access to safe-deposit boxes until the completion of the examination by the auditor. Relative to cash in bank, the comptroller should provide the auditor with an up-to-date list of all banks in which cash is on deposit, together with a list of all banks in which accounts may have been closed during the year, and all banks from which loans were received during the year. Similarly, the comptroller should have lists prepared of all assets in the hands of custodians or held by others as collateral, in order that the auditor may make arrangements either to count such securities personally, or to obtain confirmation letters from the custodians. Obviously, the
comptroller should retain copies of any and all lists, summaries, reconciliations or other accounting statements given to the auditor. These data become part of the working papers of the auditor and a part of his permanent record of the examination. The preparation of these data does not take the place of verification by the auditor, but serves in some degree as media of his audit verification and reduces the clerical detail which must otherwise be performed by the auditor's assistants.

The auditor will want to obtain direct confirmation from banks in respect of funds on deposit. When there are numerous banks, the comptroller may again relieve the auditor of clerical detail if he will cooperate in the preparation of confirmation letters in the form prescribed by the auditor. Similarly, the comptroller should have reconciliations of all bank accounts prepared and copies thereof made available to the auditor, which will serve as the basis for his verification.

**Marketable securities:**

As previously stated, these securities should be examined at the same time the cash is counted. The comptroller should prepare in advance a schedule for the auditor showing in detail the description of the securities, at the beginning and end of the year under review, with intervening columns which set forth the acquisitions and dispositions during the year, the profits and/or losses relative thereto, and a reconciliation of the income which should have been received from all such securities during the year. Here again such a schedule, if properly prepared in adequate detail, will eliminate clerical preparation on the part of the auditor and will afford him the basis upon which to pursue the verification of the representations made by the comptroller. This schedule should indicate, furthermore, both cost and market value in respect of each individual security, together with a record of the sources from which market values have been obtained, and great care should be used to be sure that such sources are sufficiently authoritative to satisfy the requirements of the auditor. Similar preparation may be made relative to treasury stock, if
any. Incidentally, when securities are encountered purporting to be the property of the corporation which are not issued in the name of the corporation or do not bear proper endorsement, the comptroller may avoid some delay if he will see to it throughout the year that securities belonging to the corporation are in proper form.

**Notes receivable:**

At the time notes receivable are presented for inspection, these documents should be accompanied by a schedule displaying all of the pertinent data relative to the name of the maker, the date of the note, interest rate, face amount, endorsements, and other related information. Care should also be exercised to see that proper distinction is made between notes receivable which have arisen as a result of normal business transactions and those notes which may have arisen as a result of extraneous or extraordinary transactions, with particular regard to the question of maturity and/or renewal which may require a distinction between those which are of the nature of current assets and those which should be excluded from current assets. The schedule of notes receivable should, of course, have due regard to the credit status of such notes, showing proper classification as to aging, default in interest or principal, with adequate reserves for amounts doubtful of collection.

**Accounts receivable—trade:**

Naturally, the comptroller will ascertain that the detailed ledgers are in balance with controls, and that copies of accounts receivable trial balances are available for the working papers of the auditor, showing a complete aging of the accounts on a basis which should have been made the subject of discussion between the comptroller and auditor before the audit began. Adequate reserves should, of course, be established for doubtful accounts and the comptroller should have discussed this question with the credit manager before the subject was taken up with the auditor. Needless to say, where individual accounts are small in amount
and large in number some restriction on the details of aging and verification of receivables will probably be agreed upon between the comptroller and auditor, provided effective internal control exists. To the extent that accounts receivable are confirmed, the comptroller may again eliminate much clerical detail on the part of the auditor by undertaking the preparation of confirmation letters and/or statements, and cooperating with the auditor in affording effective control over the checking of such confirmations, the mailing thereof, the receipt of replies, and the summarization of results obtained. Needless to say, where accounts receivable are few and large in amount, complete confirmation will be undertaken. There are, of course, special questions concerning secured accounts receivable, which involve the marketability or realizable values of the collateral, and other related questions. Trade accounts receivable should comprise only amounts due from customers for merchandise sold to them. Invoices for sales should be filed in post binders, or otherwise, so as to be readily accessible to the accountant for purposes of his testing and sampling of these transactions. In some businesses involving an unusual degree of returns or exceptional discounts or quantity allowances, it naturally follows that ample reserves to cover these items shall have been computed carefully by the comptroller and provided in the records. The comptroller should have prepared schedules of credit balances appearing in accounts receivable and should have had an investigation made into the status of these credit balances, for the purpose of expediting the examination of the auditor. Obviously, large credit balances will have to be confirmed. In businesses involving installment accounts receivable a different type of aging may be required, and in addition to reserves for doubtful accounts and loss of gross profit on returns, reserve for collection expenses, and reductions of accounts to present worth may be required. If the terms of such accounts exceed twelve months, the disclosure of that fact is desirable in the balance sheet and it is customary to exclude from current assets substantial amounts maturing later than one year from the date of the balance sheet.
Due from officers and employees and sundry debtors:

Generally, the cooperation of the comptroller in respect of these accounts takes a form similar to that relating to ordinary accounts receivable. In this case, however, the schedules will naturally be detailed and the usual questions of accrued interest, collectibility of the accounts, collateral, and similar factors will require special consideration.

Inventories:

The auditor should be furnished with a copy of the inventory instructions so that he may satisfy himself as to whether such instructions, when properly carried out, will result in a fair statement of the inventory. These instructions should be furnished to the auditor prior to the audit in order that he may be enabled to assist in correcting any theoretical errors or in supplying additional requirements which he may deem necessary or desirable. These instructions must necessarily include instructions concerning cut-off, physical count, recording and calculating inventories. Extended discussion might be devoted to the consideration of proper control of perpetual inventory and of physical count. Briefly, proper control of the physical inventory requires all inventory media to be prenumbered and accounted for at the completion of the inventory. All summaries should bear the signatures of the persons responsible for taking the inventory, making the calculations, fixing the prices and footing the sheets. Care must be exercised to retain for the auditor all count cards, tags and/or other memoranda used in connection with the physical count to afford the basis of a test check of the physical count. When a perpetual inventory has been maintained and adjusted throughout the year on the basis of continuous count, records must naturally be retained and filed in respect of such tests and adjustments.

It is necessary also that invoices shall be properly filed and readily available for price tests. Particular attention should be given to the question of goods in transit and similar care must be exercised in respect of goods on consignment, goods in public
warehouses, out for processing, defective, damaged, obsolete, or unmerchantable goods. Schedules should be prepared by the comptroller in support of these various phases of the inventory. Similarly, if a substantial decline has occurred in market price of inventory items, subsequent to the date of the balance sheet, such factors should be carefully scheduled in order that adequate reserve may be provided out of surplus for such subsequent market decline.

On the basis of purchase department records, the comptroller should be sure to have prepared comprehensive schedules relative to commitments. Similar schedules should be prepared in respect of sales commitments with due regard to the question of market values bearing upon cost and with further regard to the relation of such commitments to the normal requirements and/or facilities of the business.

Schedules prepared from shipping department records and receiving department records with regard to the effective cut-off of inventory and related adjustments of accounts receivable and accounts payable are of great importance; and, particularly, in an involved situation, the comptroller may save a great deal of time on the part of the auditor by adequate analysis and preparation.

**Prepaid expenses:**

The most usual items included under this caption are insurance and taxes. The comptroller should arrange to have prepared a schedule of insurance premiums, listing policies in detail, classified by character of insurance covered, and setting forth the spread of insurance premiums for the purpose of determining the unexpired portion as at the audit date. If these data can be substantiated by means of statements obtained from insurance agencies so much the better. The question of payroll audit relating to additional premiums on workmen's compensation insurance should be borne in mind and proper adjustments and accruals made therefor. Throughout the year the comptroller should be sure that the policies of a given classification contain
uniform, standard clauses; that policies are properly executed to the corporation; and he should be sure that these policies are all in order and made available when requested for inspection by the auditor. It will expedite matters if all vouchers concerning payment of insurance premiums during the year are "pulled" from the files and handed to the auditor at the same time that the policies and the schedule are made available to him. Incidentally, while both the comptroller and the auditor must necessarily be well informed on insurance, it is obvious that neither can be experts on the subject. If the company is sufficiently large to maintain its own internal general counsel's department, some person in that department should be constantly checking the legal aspects of insurance coverage to be sure that the interests of the company are adequately protected. In any event, if this service is not rendered by the internal legal department, periodic surveys of insurance coverage, both from the practical operating standpoint and from the legal standpoint, should be made by disinterested parties retained for the purpose. It happens all too often that "the stable door is locked after the horse is stolen".

In connection with taxes the schedule should show the kind of tax, the basis of the levy, the period covered, and the dates of payment. When the comptroller submits this schedule to the auditor he should also submit the receipted tax bills in support of the calculation of prepaid taxes appearing in the schedule. In this connection, the comptroller will naturally maintain a "tickler" to assure that tax returns are promptly filed and that assessments are promptly paid. In addition, the comptroller should prepare a detailed schedule of property, subject to real and personal property taxes subdivided by tax jurisdictions, to be sure that taxes on such property are properly disposed of. The auditor will also want to avail himself of this means (as reasonable evidence) in substantiation of the fact that title to property appearing on the books of the corporation is properly vested in the corporation. Where properties are wide-spread and material in amount the comptroller may do much to reduce the time con-
sumed in the verification of taxes and of property by the care-
ful preparation of these related schedules.

There are, of course, other items of prepaid expense relating
to advertising, royalties, interest, salaries, subscriptions, etc.,
which should, of course, be scheduled in similar fashion, and in
connection with which supporting vouchers should be readily
available.

**Investments:**

This classification may involve many kinds of investments,
more or less important, and time does not permit of a lengthy
discussion of the subject. Briefly, in contradistinction to securi-
ties classified as marketable securities under current assets repre-
senting temporary investments, the classification of investments
should comprise items of a more permanent character. Typical
examples will serve to illustrate: an automobile company may
hold a substantial block of the stock of some concern which manu-
factures parts, with the purpose of obtaining a favored posi-
tion in the purchase of such parts, or, *vice versa*, the parts manu-
ufacturer may hold a substantial block of stock of the automobile
company with the view of influencing the purchase of such parts
by the automobile manufacturer. In fact, such holdings may be
the result of agreement incident to purchase or sales contracts.
Innumerable examples of similar trade character may be readily
adduced.

If the investments represent items other than securities, their
specific character should be disclosed by separate classification.
For example, wholesalers of tobacco may have made substantial
investments in the form of advances, or otherwise, to growers of
tobacco. Over-extension of credit to customers might result in
further advances to provide working capital secured by collateral
deposit of the stock of such customer. There may be invest-
ments in land for future use of the business. All of such cases,
more or less complicated, should of course be clearly described
in the balance sheet.
There is, however, one underlying principle relating to all investments, viz.: that their carrying value may be stated at cost but not substantially in excess of the fair value of the investment, or commensurate with the return which the investment will net. Suffice it to say that the comptroller should marshal all available facts concerning such investments in order to expedite the consideration of the question by the auditor. Obviously, he should have available financial statements of the most authentic character possible of companies underlying such investments.

**Capital assets:**

In connection with an initial examination, the auditor will want to vouch substantially the cost of acquisition of all such assets. It may be assumed for present purposes that a recurring examination is being dealt with, in which event the balances at the beginning of the year will have been previously substantiated and the auditor is then concerned with changes during the year. These changes involve additions, dispositions, depreciation, and related matters. There should be, of course, a perpetual record of the fixed assets of the company with a sufficiently detailed classification to harmonize with depreciation rates relating to the several classes of such assets. Underlying such perpetual record there should also be plats of the Company’s holdings of property on which should be indicated the land and leaseholds owned, and the buildings, if any, erected thereon. The files relating to titles, deeds, mortgages, etc. should be in good order and the minutes of the corporation should take adequate cognizance of important acquisitions and sales of property. (As a matter of fact, the comptroller’s schedules of capital assets probably will now be revised in sufficient detail to fit the requirements of Treasury Department decision 4422.) In support of additions to fixed assets during the year he will have obtained authorizations or appropriations, properly approved by the Board of Directors or by the designated authority, and he will see that all vouchers and documents relating to construction and acquisition will be readily available for examination by the auditor.
It is self-evident that where the ramifications of fixed assets are material, as they are in any industrial enterprise, an important saving in the work to be done by the auditor may be made as the result of proper preparation by the comptroller.

The thought will bear repeating: that the key-note to cooperation between the comptroller and the auditor lies in the proper assembling of evidence and its summarization in such form as will adequately serve the purpose of the auditor in the conduct of his examination.

**Goodwill and other intangibles:**

Goodwill in its commercial sense comprehends all those elements usually regarded as contributing something to the exceptional earning power of a business. The valuation of goodwill may be pertinent upon the purchase of a business or under similar circumstances, but in the balance sheet of a going concern the item is gradually falling into disrepute. Even though a valuation may have been accurately and scientifically determined, and even though goodwill may in fact have been bought and paid for, it represents an intangible which has a constantly fluctuating value, depending upon the future course of the business. If the business continues to be increasingly successful the true value of goodwill should increase commensurately. If the business is less successful there is in fact a relative decrease in the value of goodwill and, obviously, if the business suffers a loss the goodwill is in fact valueless (from the standpoint of producing exceptional earnings). The trend in recent years has been to reduce the value to a nominal sum by writing off the item against surplus or, if necessary, creating surplus by reduction of capital stock for the purpose of such elimination.

On the other hand, there are certain other intangibles in the form of patents, copyrights, and similar items which, if bought and paid for, do have a place in the balance sheet; but such intangibles are subject to amortization depending upon their fixed life. Copyrights, under Act of Congress, have a statutory life of twenty-eight years with the privilege, under certain circum-

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stances, of renewal for another twenty-eight years. Patents are issued for seventeen years and are not renewable. At the expiration of these periods whatever value continues to inure to patents, processes, copyrights, or trade-marks partakes of the nature of goodwill in the sense that buyers have become accustomed to seek a certain product (similar to the goodwill which relates to a location with the implication that purchasers have become accustomed to go to that particular location for the purchase of a particular product).

As regards any intangibles acquired during the year under review, the auditor will necessarily have to inspect all pertinent documents to substantiate the propriety of the charges appearing on the books. Here again the problem of the comptroller is to marshal his facts intelligibly.

**Notes payable:**

The comptroller should prepare a complete schedule of notes payable existing at the beginning and at the end of the period, together with the intervening reconciliation respecting notes executed during the year, notes liquidated during the year, etc. This schedule should show in detail the dates of notes, payees, the character of the notes, due dates, interest dates, amounts, and collateral, if any. The schedule should be supported by all cancelled notes representing indebtedness liquidated during the year; and the comptroller may also cooperate with the auditor in the clerical preparation of confirmations which will have to be sent to holders of notes outstanding at the close of the period. The comptroller should satisfy himself throughout the year that notes payable of the corporation are executed by officers properly authorized to execute such documents.

**Accounts payable:**

It goes without saying that the comptroller will have the trial balances of accounts payable ledgers in agreement with the controls, regularly, throughout the year and certainly at the close of the fiscal period. If a voucher system is in use, without support-
ing accounts payable ledgers, the comptroller will see that re-
conciliations of unpaid vouchers will be effected regularly at the close of each month. When vendors' invoices are not settled by specific payment, and certainly when payments on account are made, the maintenance of accounts payable ledgers in addition to vouchers payable will be found essential unless some practicable device be found in substitution. The subject of proper internal control relating to accounts payable, approval of vouchers, etc. has been discussed previously as has also the subject of inventory cut-off and related questions concerning unrecorded liabilities at the close of the year. The comptroller should assemble his evidence and schedule it. Certainly, he will have a schedule of vouchers payable and will have the underlying documents readily available. Particularly in respect of debit balances in accounts payable, a clean-up campaign should be instituted by the comptroller before the close of the year with the view of eliminating such items. Those that remain unadjusted will be scheduled, together with supporting documents and other information and explanations relative thereto.

**Accrued expenses payable:**

This classification will comprise such items as accrued salaries, interest, taxes, royalties, rents, insurance, water, gas, electricity, and all other similar items which accrue regularly but which are not yet due for payment and concerning which bills have not yet been received, or if received involve installments payable at subsequent dates. In support of these items the comptroller should prepare a schedule supported by all related documents.

**Federal and state taxes payable:**

The amounts of such accrued taxes, together with obligations for additional assessments relating to prior periods, etc., should be estimated by the comptroller and set up on the books. The accounts should be supported by detailed schedules, together with related documents. For both federal capital stock tax and New York State franchise tax, the entire liability, if any, at the date
of the balance sheet, should be set up and that portion which belongs to a period subsequent to the audit date should be treated per contra under deferred charges.

**Twenty-year 5% gold bonds:**

It appears from the accompanying balance sheet that these bonds must have been sold at par as there is no deferred charge relating to discount on the issue. If a discount were involved the comptroller should have prepared a schedule relating to the amortization of such discount. If any bonds have been reacquired these will be held readily available for inspection and the comptroller will schedule such reacquisitions. A copy of the complete indenture underlying the issue will have been made available to the auditor and the comptroller will cooperate in obtaining confirmations from the trustees under the indenture relative to the face value of bonds outstanding at the audit date, etc.

**Mortgages payable:**

Changes which may have occurred in this account during the year, such as adjustments of principal, interest rates and maturities, should be amply scheduled by the comptroller and supported by all related documents. The face values of the mortgages outstanding at the audit date will be verified by means of a confirmation obtained from the holder thereof.

**Reserve for contingencies:**

The comptroller should make a special study of this situation before the close of the year in connection with any litigation, contracts, or other commitments. He will have prepared a memorandum quoting references from the minutes and will have available all documents relating to such contingencies. The kinds of contingencies against which reserves may be provided are so numerous that it will probably serve the purpose best to state certain fundamental principles which relate to these items. If they represent contingencies which apply specifically to the operations of the year under review, provision for them should
be made out of operations for that year. If the contingencies refer to future events they should be provided for by appropriation of surplus. When such contingency becomes an accomplished fact the expense should be charged to profit and loss and the reserve theretofore established should be reversed to surplus whence it came. In any event the provision should be made in respect of the reasonable expectancy of the amount of the obligation and if the amount be indeterminable conservative provision should be made. If the transactions passed through reserve for contingencies are material in their effect upon the balance sheet or upon the operations a clear disclosure of such transactions should be made in published financial statements. Reserves for contingencies should be used neither for the purpose of equalizing profits between years, nor for relieving operations of charges which normally should be carried through profit and loss account.

**Capital stock:**

Any changes in authorized capital stock during the year will naturally be supported by appropriate action taken by the Board of Directors and/or of the stockholders of the corporation as may be required by law, and evidenced by certificates of authority issued by the Secretary of State.

Larger companies employ external registrars and transfer agents from whom certificates may be obtained showing the amount and classification of capital stock outstanding at the date of the balance sheet. This external service eliminates all the work of recording and transferring stock as well as the payment of dividends. In the event that these services are not provided, the verification of capital stock outstanding becomes a more complicated task. Under such circumstances the comptroller should arrange to have the open certificate stubs scheduled and reconciled with the general ledger account of capital stock outstanding. Such a schedule should also present all the changes which have taken place during the year. Such changes should be supported by agreements, reference to cash transactions and,
possibly, some reference to the minutes. In these circumstances, also, cancelled stock must be examined to see that adequate mutilation of the certificates has been effected to prevent reissuance or improper dealing in such stock. Reference has previously been made to the verification of capital stock reacquired. Any and all changes in the articles of incorporation of the corporation effected during the year should find reflection in the minutes and in documents received from the Secretary of State authorizing such changes. These documents should, of course, be readily available.

When preferred stock issues have retirement or sinking fund provisions, the transactions relative to such requirements should be adequately scheduled by the comptroller and should be supported by underlying documents. When the company itself acts as its own registrar and transfer agent the comptroller should conduct an investigation before the close of the year to see that statutory regulations concerning revenue stamps have been properly observed.

**Surplus:**

The comptroller should have prepared a detailed schedule setting forth all the changes in surplus accounts during the year and he should also have arranged to have all the supporting documents regarding such changes readily accessible. The comptroller should also satisfy himself that sound accounting principles have been observed relative to the distinctions between earned surplus and the various classes of capital surplus. Declarations and payments of dividends should, of course, be supported by resolutions appearing in the minutes of directors’ meetings, and in this respect also the comptroller should satisfy himself at the time such dividends are authorized that such dividends may be declared and paid legally. Dividends in arrears on cumulative preferred stock should be calculated and a memorandum thereof made available to the auditor.

Generally speaking, minor adjustments affecting prior periods should be cleared through the profit and loss account of the
current year, and before the audit is undertaken the com­
troller should satisfy himself that such minor adjustments have 
not found their way into earned surplus. There may be unusual 
circumstances under which major charges to earned surplus may 
be made, but in ordinary circumstances such charges should 
appear as extraordinary deductions in the statement of profit and 
loss for the year under review.

Profit and loss:

The subject of our discussion does not contemplate an exhaus­
tive consideration of the operating accounts. Some reference 
has been made to the subject in the discussion of internal control. 
Suffice it to say, that the extent of the testing and sampling of the 
details of operating accounts for the year under review will de­
pend primarily upon the established effectiveness of the system of 
internal control. In any event, the comptroller should have pre­
pared and submitted to the auditor schedules arranged in comp­
parative form covering the current year and the prior year and 
analyzed by months, or by major sub-classifications, in respect 
of all the major classifications of profit and loss. As regards 
sales and cost of sales these schedules should be supplemented by 
data relating to units of production and will serve as a basis of 
discussion between the comptroller and auditor, also as a basis 
for such further investigation of the several classifications of 
profit and loss as, in the opinion of the auditor, may require in­
vestigation or review.

The essence of cooperation:

The viewpoint of the comptroller and of the public accountant 
respecting the financial statements of the corporation should be 
identical in the purpose sought to be served, viz. a fair disclosure 
of all material facts relating to the financial position and result 
of operations of the business. Essentially, the comptroller 
should be a man of sufficient technical knowledge and experience 
to be able to produce reliable financial statements. His approach 
to the problems differs from that of the public accountant only
to the extent that, being on the job the year around, he has the opportunity of interpreting transactions as they arise, whereas the public accountant passes upon everything in retrospect in connection with the annual financial examination. However, many transactions interpreted by subordinates as normal may in fact involve abnormal conditions, and some of these transactions may temporarily get into the records without having come to the comptroller for consideration. Some of these will be disclosed to him during the year as the result of internal audits conducted under his supervision or as the result of studies and analyses undertaken under his direction.

In preparing his annual financial statements he should reconsider every classification and weigh them in the light of sound accounting principles. To do this he must necessarily prepare or have prepared for him summarized schedules which at least present the highlights of every classification, and he must require his subordinates and his executive associates in the business to produce for him the documentary evidence upon which the interpretation of transactions must depend. The more thorough a job he does in this respect the simpler will be the examination conducted by the public accountant. The essence of cooperation between the comptroller and the public accountant, therefore, lies in the degree to which the comptroller marshals and summarizes the evidence supporting the interpretation of transactions which he has approved.

THE SECURITIES ACT AND SECURITIES EXCHANGE ACT

The Securities Act:  

The enactment of the Securities Act of 1933 has brought into prominence the responsibilities of corporate officers for the disclosure of material facts in the financial statements of corporations and has established definite liabilities for failure to disclose such material facts. The Act is aimed particularly at the protection of investors in respect of new issues of securities, and provides that no interstate offering of securities shall
be made unless there be filed with the Commission a registration statement signed by the issuer, its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer, and a majority of the Board of Directors or persons performing similar functions, and the signature of any expert (accountants, appraisers, etc.) as to parts of the registration statement for which they may have assumed responsibility.

The registration statement must include such information as the Commission may by its rules or regulations require as being necessary or appropriate for the protection of investors. Failure to disclose material facts, or the omission to state a material fact required to be stated "to make the statement therein not misleading", subjects to severe civil liability every person who has signed the registration statement.

In the Act as amended in 1934, the plaintiff must sustain the burden of proof. Belief in respect of the disclosure of material facts on the part of the defendant means that the defendant had no reasonable grounds to believe and did not believe that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.

**Securities Exchange Act:**

The Securities Exchange Act states the necessity for regulation in Section 2 of that Act as follows:

"Transactions in securities as commonly conducted upon security exchanges and over the counter market are affected with a national public interest which makes it necessary to provide for the regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulations and control reasonably complete and effective, in order to protect interstate commerce, the national credit and the federal taxing power; to protect and make more effective the national banking systems and federal reserve systems, and to insure the maintenance of fair and honest markets in such transactions."
The Act provides for the creation of a securities exchange commission authorized to administer the Act, and makes it unlawful for any exchange to afford facilities for dealing in securities unless the exchange be licensed as a national securities exchange. It provides for the promulgation of elaborate regulations relative to (a) margin requirements, (b) restrictions on borrowings by members, brokers and dealers, and (c) prohibition against manipulation of security prices.

In so far as corporations are concerned, section 12 of the Act provides that it shall be unlawful for any member, broker or dealer to effect any transaction in any security on a national securities exchange unless a registration is effective as to such security for such exchange in accordance with the provisions of the law and the rules and regulations promulgated by the Commission. A security may be registered on a national securities exchange by the issuer filing an application with the exchange and with the Commission; and the law provides that such registration statement shall include much the same information as has long been required in listing applications on the New York Stock Exchange with the following additions:

(1) The terms under which the securities are to be, and during the preceding three years have been, offered to the public;

(2) The directors, officers and underwriters and each security holder of record holding more than 10% of any class of security, their remuneration and their interest in the securities of, and their material contracts with, the issuer;

(3) Remuneration to others than directors and officers exceeding $20,000.00 per annum;

(4) Bonus and profit-sharing arrangements;

(5) Management and service contracts;

(6) In addition to the usual financial statements for three years, any further financial statements which the Commission may deem necessary or appropriate for the protection of investors.
The Act goes on to provide for periodical and other reports, stating specifically that every issuer shall file such information and documents with the securities exchange commission.

Directors, officers and principal stockholders are, by the Act, required to file periodic reports setting forth any changes in their holdings of the securities of the issuer, and any profit realized by such person in respect to such transaction within any period of less than six months shall inure to the benefit of the issuer.

Any person who makes any statement in any application, report or document filed pursuant to the Act, which statement was at the time, and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, shall be liable for damages caused by such reliance unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false and misleading.

These brief references to the substance of these two Acts pointedly emphasize the new duties of the comptroller, not alone to protect himself as a responsible official of the corporation, but also to protect the officers of his company against any oversight or misinterpretation of transactions which the application of his technical knowledge to the matter might avoid. The comptroller should be careful to weigh each and every transaction on the basis of the question: "Is this a material fact, and will the treatment which I am according it in the accounts result in a failure to disclose such material fact?" If the rule relating to disclosure of material fact is ethically sound (and it would seem that no right-minded individual can take exception to the principle) it must follow that it should be accepted as a criterion in the preparation of financial statements generally, regardless of whether the preparation of such financial statements be related to the issuance of new securities and whether or not they be related to a company whose securities are listed on a licensed exchange.

It is true that there are grave questions as to the reasonableness of the liability imposed upon officers, directors and experts.
There are grave doubts as to what constitutes a material fact, particularly those material facts which may escape the consideration of all interested parties concerned, and there are other questions of whether these Acts have not unduly hampered the legitimate flow of capital.

The object of the legislation has been to protect investors by prescribing the character of information which must be disclosed in offering securities for sale, but not to prescribe the particular kind of security to be issued, nor, in any sense, to place the stamp of approval of the government upon the merit of securities issued. In fact, some eminent counsel maintain that "cats and dogs" may still be sold, provided all material facts are disclosed.

A sound working knowledge of the aims and operations of the Securities Act and the Securities Exchange Act is an essential part of the equipment of a competent comptroller, and those who have not yet done so should at the earliest opportunity study this new legislation.

IN CONCLUSION

The New Deal has brought with it new concepts of the relative importance of human rights and property rights. The affairs of industry lie at the core of our economic structure. Whether we be Whigs or Tories we must recognize the changes and, in any event, resign ourselves to new conditions, adjusting our attitudes to the conventions of the game. The place which the comptroller fills in the picture, as an adviser of management in the construction of published financial statements as well as in all matters relating to general business conduct, takes on added importance under the New Deal, and is in line with the transition from rugged (or shall we say ruthless) individualism to that of cooperation for the common weal. The comptroller and the public accountant may well consolidate and coordinate their opinions and knowledge in a constantly alert service of management.
**ENIGMA MANUFACTURING CORPORATION**

**Balance Sheet, October 31, 1934**

**Assets**

<table>
<thead>
<tr>
<th>Current Assets:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$5,000,000.00</td>
</tr>
<tr>
<td>Marketable securities, at market values, not in excess of cost</td>
<td>2,000,000.00</td>
</tr>
<tr>
<td>Notes receivable, trade</td>
<td>100,000.00</td>
</tr>
<tr>
<td>Accounts receivable, trade, less reserve ($500,000.00)</td>
<td>4,000,000.00</td>
</tr>
<tr>
<td>Due from officers and employees</td>
<td>50,000.00</td>
</tr>
<tr>
<td>Sundry debtors</td>
<td>50,000.00</td>
</tr>
<tr>
<td>Inventories, valued on the basis of cost or market, whichever is lower</td>
<td>15,000,000.00</td>
</tr>
</tbody>
</table>

| Prepaid Expenses                                     | 100,000.00 |

| Investments, at cost (not in excess of fair values) | 500,000.00 |

<table>
<thead>
<tr>
<th>Capital Assets:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Valued at cost:</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$1,999,999.00</td>
</tr>
<tr>
<td>Reserve for depreciation</td>
<td></td>
</tr>
<tr>
<td>Gross</td>
<td></td>
</tr>
<tr>
<td>Net</td>
<td>$1,999,999.00</td>
</tr>
<tr>
<td>Buildings</td>
<td>20,000,000.00</td>
</tr>
<tr>
<td>Reserve for depreciation</td>
<td>7,000,000.00</td>
</tr>
<tr>
<td>Net</td>
<td>13,000,000.00</td>
</tr>
<tr>
<td>Machinery</td>
<td>24,000,000.00</td>
</tr>
<tr>
<td>Reserve for depreciation</td>
<td>5,000,000.00</td>
</tr>
<tr>
<td>Net</td>
<td>19,000,000.00</td>
</tr>
<tr>
<td>Furniture and fixtures</td>
<td>1,000,000.00</td>
</tr>
<tr>
<td>Reserve for depreciation</td>
<td>500,000.00</td>
</tr>
<tr>
<td>Net</td>
<td>500,000.00</td>
</tr>
<tr>
<td>Automobiles</td>
<td>100,000.00</td>
</tr>
<tr>
<td>Reserve for depreciation</td>
<td>50,000.00</td>
</tr>
<tr>
<td>Net</td>
<td>50,000.00</td>
</tr>
</tbody>
</table>

| Goodwill                                             | 1.00   |

**Total Assets** | **$61,350,000.00**
**ENIGMA MANUFACTURING CORPORATION**

**Balance Sheet, October 31, 1934**

<table>
<thead>
<tr>
<th>LIABILITIES</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CURRENT LIABILITIES:</strong></td>
<td></td>
</tr>
<tr>
<td>Notes payable, banks</td>
<td>$1,000,000.00</td>
</tr>
<tr>
<td>Accounts payable, trade</td>
<td>3,000,000.00</td>
</tr>
<tr>
<td>Accrued expenses payable</td>
<td>1,000,000.00</td>
</tr>
<tr>
<td>Federal and state taxes payable, based on income</td>
<td>1,000,000.00</td>
</tr>
<tr>
<td><strong>$6,000,000.00</strong></td>
<td></td>
</tr>
<tr>
<td><strong>FIXED LIABILITIES:</strong></td>
<td></td>
</tr>
<tr>
<td>Twenty year 5% bonds, due July 1, 1939</td>
<td>$10,000,000.00</td>
</tr>
<tr>
<td>Mortgages payable, due October 31, 1944</td>
<td>10,000,000.00</td>
</tr>
<tr>
<td><strong>20,000,000.00</strong></td>
<td></td>
</tr>
<tr>
<td><strong>RESERVE FOR OTHER CONTINGENCIES</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1,000,000.00</td>
</tr>
<tr>
<td><strong>NET WORTH:</strong></td>
<td></td>
</tr>
<tr>
<td>Capital stock:</td>
<td></td>
</tr>
<tr>
<td>6% cumulative preferred stock; par value $100.00 per share:</td>
<td></td>
</tr>
<tr>
<td>Authorized and issued</td>
<td>100,000</td>
</tr>
<tr>
<td>Less in treasury</td>
<td>60,000</td>
</tr>
<tr>
<td></td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td>$4,000,000.00</td>
</tr>
<tr>
<td>Common stock, par value $10.00 per share:</td>
<td></td>
</tr>
<tr>
<td>Authorized and issued</td>
<td>1,000,000</td>
</tr>
<tr>
<td></td>
<td>10,000,000.00</td>
</tr>
<tr>
<td></td>
<td>$14,000,000.00</td>
</tr>
<tr>
<td>Earned surplus, per statement attached</td>
<td>20,350,000.00</td>
</tr>
<tr>
<td></td>
<td>34,350,000.00</td>
</tr>
<tr>
<td><strong>$61,350,000.00</strong></td>
<td></td>
</tr>
</tbody>
</table>