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THE STATEMENT OF APPLICATION OF FUNDS

It is the established practice of many public accountants to include a comparative balance-sheet in their annual reports. This comparative balance-sheet shows the assets, liabilities, and capital both at the beginning and at the end of the period under review, together with the increases and decreases in the various items. Such a statement shows the changes in the financial condition during the period, and furnishes the auditor with a basis for commenting upon the various changes in assets and liabilities.

Many accountants have felt that the comparative balance-sheet did not go far enough in organizing the material in such a way as to give a clear and comprehensive conception of the change in the financial condition caused by the profits of the period, the dividend payments, and any financing programme which may have taken place. A comparative balance-sheet merely shows the change in each balance-sheet item; it does not classify similar items in such a way as to show, for instance, the total increase or decrease in the fixed assets, and the change in the working capital. Nor does it indicate in a clear manner the means which enabled the corporation to effect the changes shown.

The statement of application of funds, often called the statement of resources and their application, has been devised in order to overcome these objections to the comparative balance-sheet. The statement of application of funds not only classifies the information which is usually shown in a comparative balance-sheet, but it also goes beyond the balance-sheet figures, and furnishes more or less detailed information as to the causes of the various changes in the assets and liabilities.

As a simple illustration, the following comparative balance-sheet is shown. This is followed by a statement of application of funds, utilizing the information shown by the comparative balance-sheet and certain other data which would have to be obtained from the books:

THE A COMPANY
Comparative Balance-sheet
Assets

	Dec. 31, 1921	Dec. 31, 1922	Decrease	Increase
Real estate	$50,000.00	$60,000.00		$10,000.00
Inventories	12,000.00	13,500.00		1,500.00
Accounts receivable	7,500.00	6,500.00	$ 1,000.00	
Cash	2,000.00	2,200.00		200.00
	$71,500.00	$82,200.00		
Net increase			10,700.00	
			$11,700.00	$11,700.00

	Liabilities			
Capital stock	$40,000.00	$45,000.00		$ 5,000.00
Surplus	27,500.00	34,200.00		6,700.00
Accounts payable	4,000.00	3,000.00	$ 1,000.00	
	$71,500.00	$82,200.00		
Net increase			10,700.00	
			$11,700.00	$11,700.00

The statement of application of funds is an attempt to classify the comparative balance-sheet information and other data in such a way as to show the sources from which additional resources were obtained for the business, and the application which was made of these additional resources. The comparative balance-sheet shows that additional funds of $5,000.00 were obtained by an issue of capital stock. It also shows that the surplus has increased $6,700.00, and the first assumption might be that the profits for the year had supplied additional resources of $6,700.00. An examination of the surplus account, however, shows that a dividend of 10% was paid on the capital stock outstanding at the beginning of the year. If this dividend had not been paid, the surplus would have increased $10,700.00; therefore any statement intended to show what resources or funds were provided during the year, ought to show that the profits provided funds of $10,700.00, and that $4,000.00 of funds were used for the payment of dividends.

The following statement of application of funds is made up from the foregoing comparative balance-sheet and the additional information as to profits and dividends:

THE A COMPANY

Statement of application of funds
for the year ended December 31, 1922

Funds provided:	
By net profits	$10,700.00
By issue of capital stock	5,000.00
Total funds provided	$15,700.00
Funds applied:	
To payment of dividends	$ 4,000.00
To increase in real estate	10,000.00
To increase in working capital (per schedule)	1,700.00
	$15,700.00

SCHEDULE OF WORKING CAPITAL

	Dec. 31, 1921	Dec. 31, 1922	*Working capital* Decrease	Increase
Current assets:				
Inventories	$12,000.00	$13,500.00		$ 1,500.00
Accounts receivable	7,500.00	6,500.00	$ 1,000.00	
Cash	2,000.00	2,200.00		200.00
Total current assets.	21,500.00	22,200.00		
Current liabilities:				
Accounts payable	4,000.00	3,000.00		1,000.00
Working capital	$17,500.00	$19,200.00		
Increase in working capital ..			1,700.00	
			$ 2,700.00	$ 2,700.00

Attention is directed to the method of showing the facts in connection with the working capital. The statement of application of funds shows only the net change of $1,700.00 in the working capital. This net change is supported by a separate schedule of working capital. This schedule shows the current assets at both the beginning and the end of the period; it also shows the current liabilities at both dates; and it shows the working capital of $17,500.00 at December 31, 1921, and the working capital of $19,200.00 at December 31, 1922. The two columns showing changes in working capital require some explanation. If the current assets have increased, the working capital has been correspondingly increased; hence increases in current assets are shown in the working capital increase column. But if current liabilities have decreased, the working capital has increased; hence the working capital increase column shows both increases in current assets and decreases in current liabilities. The working capital decrease column shows decreases in current assets and increases in current liabilities.

The foregoing illustration is intentionally a very simple one; but in preparing a statement of application of funds for incorporation in a report, an auditor is usually confronted by the necessity of making a great many adjustments. Under such circumstances the preparation of the statement becomes a difficult and complicated matter, and it is often helpful to organize the figures in working papers. The following illustration serves as a simple introduction to the working papers which will be used later in this article for the assembling of data in more complicated statements. These working papers are based upon the foregoing illustration.

STATEMENT OF APPLICATION OF FUNDS—WORKING PAPERS

	Dec. 31, 1921	Dec. 31, 1922	*Year's excess* Debits	*Year's excess* Credits	*Adjustments* Debit	*Adjustments* Credit	*Working capital* Increase	*Working capital* Decrease	*Funds* Applied	*Funds* Provided
Assets:										
Real estate	$50,000	$60,000	$10,000						$10,000	
Inventories	12,000	13,500	1,500				$ 1,500			
Accounts receivable	7,500	6,500		$ 1,000				$ 1,000		
Cash	2,000	2,200	200				200			
	$71,500	$82,200								
Liabilities:										
Capital stock	$40,000	$45,000		5,000						$ 5,000
Surplus	27,500	34,200		6,700	$10,700(a)	$ 4,000(b)				
Accounts payable	4,000	3,000	1,000				1,000			
	$71,500	$82,200								
Funds provided by profits						10,700(a)				10,700
Dividends paid					4,000(b)				4,000	
			$12,700	$12,700	$14,700	$14,700				
Increase in working capital								1,700	1,700	
							$ 2,700	$ 2,700	$15,700	$15,700

The working papers are prepared in the following manner:

The assets and liabilities at the two dates are entered in the first two columns. The amounts to enter in the year's excess debits and credits columns are next computed. The real estate account has increased; this increase was caused by excess debits during the year. The inventories have also increased as a result of excess debits. The accounts receivable have decreased as a result of excess credits. The capital stock increase represents excess credits; the surplus increase also represents excess credits; while the decrease in the accounts payable represents an excess debit.

Since changes in fixed assets are shown as funds applied, the $10,000.00 increase in the real estate is carried to the funds applied column, which is a debit column. The changes in inventories, accounts receivable, cash, and accounts payable, are entered in the working capital columns; the net increase of $1,700.00 is entered as a balancing figure in the working capital decrease column and is carried to the funds applied column. The increase in capital stock is carried to the funds provided column. The $6,700.00 net change in the surplus is analyzed by two adjustment entries; the first entry transfers $10,700.00 from the surplus line to the separate line called funds provided by profits; this $10,700.00 is then carried to the funds provided column. The $4,000.00 dividend is transferred from the surplus line to a separate line called dividends paid; this amount is then carried to the funds applied column.

The two adjustments in the foregoing illustration accomplish the breakdown of the $6,700.00 change in the surplus account. The following illustration is somewhat more extended, and it involves a number of adjustments. The breakdown of the $3,805.00 increase in the surplus account includes four items, and there are adjustments in several of the other accounts:

In the first place, the profits shown by the profit-and-loss statement for the year, were $10,805.00; this amount is transferred from the surplus line to the section at the bottom of the working papers, called funds provided by profits. This transfer commences the breakdown of the change in the surplus balance, and is accomplished by adjustment (a).

The next adjustment is one which almost invariably appears in statements of application of funds, and is one which must therefore be clearly understood. During the year $500.00 was charged to operations and credited to the reserve for depreciation, thus increasing the reserve. Adjustment (b) transfers this $500.00 increase in the reserve for depreciation to the section called funds provided by profits. This transfer is made because the funds provided by the profits were really larger than the profits themselves. To understand why this is, let us assume that a man is doing a cash business; he buys goods which cost $5,000.00 and sells them for $6,000.00, thus making a profit of $1,000.00. He also pays expenses of $200.00 leaving a profit balance of $800.00. Thus it appears that the profits have increased his cash $800.00. But he has a small investment in certain fixed assets which are subject to depreciation and he proceeds to make a book entry debiting profit-and-loss and crediting the reserve for depreciation $50.00. This reduces the balance of the profit-and-loss account to $750.00, but it does not reduce the cash funds provided by the profits. These funds remain at $800.00. Hence to find the funds provided by the profits, we must add the net profit per books and the depreciation provision.

Adjustment (c) is made for similar reasons. Operations were charged $1,000.00 on account of the patent expiration expense applicable to the year. While this $1,000.00 reduced the profits for the year, it did not reduce the funds brought in by the profits, and hence this $1,000.00 credit in the patent account is transferred from the patent line to the net profit line as an adjustment to determine the funds provided by the profits.

Adjustment (d) is made in order to show the net funds provided by the bond issue. The bond account shows an increase of $20,000.00 during the year, which was the par of the bonds issued. Against this there appears a bond discount account of $1,900.00. The analysis of this account, obtained from the books shows that it was charged with $2,000.00 discount on the issue of the bonds; and since the bonds were to mature in twenty years, 1/20 of the discount has been written off. Now since the bonds were issued at a 10% discount, the $20,000.00 par of bonds produced only $18,000.00 of funds. In order to show this fact in the working papers $2,000.00 of bond discount is transferred from the bond discount line to the bonds payable line reducing the $20,000.00 balance of the bonds payable to $18,000.00, the net funds provided.

Referring to the bond discount line we find that the $1,900.00 item in the year's excess debit column and the $2,000.00 credit adjustment leave a $100.00 balance in the account. This is the amount of discount written off during the year, and the amount of the charge to profit and loss. But this was merely a book entry which had no effect upon the funds. In other words this charge to profit and loss did not require an expenditure of funds nor did it reduce the amount of funds provided by the profits. Therefore adjustment (e) is made transferring the $100.00 to the funds provided by the profits section of the working papers.

An analysis of the land account shows that the $5,000.00 increase during the year was the result of an appraisal, and that an entry was made debiting the land account and crediting surplus. As this debit to land does not represent an expenditure of funds, and as the credit to surplus does not represent a provision of funds, the entry is reversed in the adjustment columns by debiting surplus and crediting the land account.

During the year a stock dividend of $8,000.00 was paid. This stock dividend involved a transfer of $8,000.00 from surplus to capital stock, increasing the balance of the latter account $8,000.00. This increase of the capital stock does not represent a provision of funds, and hence adjustment (g) is made reversing the entry recording the stock dividend. This entry eliminates the $8,000.00 change in the balance of the capital stock account because the stock dividend had no effect upon the funds.

During the year a cash dividend of $4,000.00 was paid. In order to complete the breakdown of the change in the surplus balance, and also in order to show the cash dividend as an application of funds, the $4,000.00 is transferred by adjustment (h) from the surplus line to a separate line called cash dividend.

The next step is to make the distribution in the working capital and the funds columns. The $5,000.00 change in the land account has been eliminated by an adjustment; hence it is not to be carried out to either the working capital or the funds columns. The $30,000.00 increase in the building account is carried to the funds applied column. The change in the patents account has been eliminated. The $5,000.00 decrease in the bond investment account is carried to the funds provided column. The increase in the inventory is shown as an increase in the working capital. The decrease in the accounts receivable is carried to the working capital decrease column. At this point attention is called to the treatment of the reserve for bad debts. This reserve has increased $10.00 during the year. This $10.00 might be added back to the profits in the same way that the provision for depreciation was added back. It seems preferable, however, to carry this change in the reserve into the working capital column, because the accounts receivable and the reserve for bad debts must be considered together in determining the amount of the working capital. In the schedule of working capital the accounts receivable at the beginning and at the end will be entered at the net amount after deducting the reserves at the two respective dates, and the change in the accounts receivable will be the sum of the $150.00 decrease in the account receivable and the $10.00 increase in the reserve.

The increase in the unexpired insurance is entered in the working capital column. In the statement of application of funds the change in working capital and deferred charges will be shown as a single item. The deferred charge item should be itemized below the working capital items in the schedule of working capital and deferred charges.

The change in the capital stock has been eliminated. The change in the surplus has been broken down and the several elements which caused the net change have been transferred to various places in the working papers. The change in the reserve for depreciation has been eliminated by transfer to the profits. The net amount of the bond issue, that is $20,000.00 minus $2,000.00 discount, is carried to the funds provided column. The increase in the accounts payable is carried to the working capital decrease column.

The total funds provided by the profits are now computed by adding the net profit per books and the three items which decreased the net profits but did not reduce the funds provided by the profits. The addition of these four items produces a total of $12,405.00 of funds provided by profits.

The cash dividend is carried out as an application of funds.

THE B COMPANY

Statement of Application of Funds—Working Papers

	Dec. 31, 1921	Dec. 31, 1922	*Year's excess* Debit	*Year's excess* Credit	*Adjustments* Debit	*Adjustments* Credit	*Working capital* Increase	*Working capital* Decrease	*Funds* Applied	*Funds* Provided
Assets:										
Land	$15,000	$20,000	$ 5,000			$ 5,000(f)				
Buildings	65,000	95,000	30,000						$30,000	
Patents	17,000	16,000		$ 1,000	$ 1,000(c)					
Investment in X Co. bonds	5,000			5,000						$ 5,000
Inventories	18,000	19,600	1,600				$ 1,600			
Accounts receivable	3,000	2,850		150				$ 150		
Cash	2,700	2,900	200				200			
Unexpired insurance ..	300	315	15				15			
Bond discount		1,900	1,900		100(e)	2,000(d)				
	$126,000	$158,565								
Liabilities:										
Capital stock	$ 80,000	$ 88,000		8,000	8,000(g)					
Surplus	41,600	45,405		3,805	5,000(f)	8,000(g)				
					10,805(a)	4,000(h)				
Reserve for depreciation	1,000	1,500		500	500(b)					
Reserve for bad debts..	150	160		10				10		
Bonds payable		20,000		20,000	2,000(d)					18,000
Accounts payable	3,250	3,500		250				250		
	$126,000	$158,565	$38,715	$38,715						
Funds provided by profits:										
Net profit per books						10,805(a)				
Add: Depreciation..						500(b)				
Write-off of patents						1,000(c)				12,405
Write-off of bond discount						100(e)				
Cash dividend					4,000(h)				4,000	
					$31,405	$31,405				
Increase in working capital and deferred charges								1,405	1,405	
							$ 1,815	$ 1,815	$35,405	$35,405

The following statement of application of funds, with its supporting schedule of working capital and deferred charges, was prepared from the foregoing working papers:

THE B COMPANY
Statement of application of funds
for the year ended December 31, 1922

Funds provided:		
By net profits:		
Net profits per books	$10,805	
Add: Depreciation	500	
Write-off of patents	1,000	
Write-off of bond discount	100	$12,405
By issue of bonds at 90		18,000
By sale of bonds of the X company		5,000
Total funds provided		$35,405
Funds applied:		
To increase in buildings		$30,000
To payment of cash dividend		4,000
To increase in working capital and deferred charges (per schedule)		1,405
Total funds applied		$35,405

SCHEDULE OF WORKING CAPITAL AND DEFERRED CHARGES

	Dec. 31, 1921	Dec. 31, 1922	Working capital Decrease	Working capital Increase
Current assets:				
Inventories	$18,000	$19,600		$ 1,600
Accounts receivable (less reserve)	2,850	2,690	$ 160	
Cash	2,700	2,900		200
Total current assets	$23,550	$25,190		
Current liabilities:				
Accounts payable	3,250	3,500	250	
Working capital	$20,300	$21,690		
Increase in working capital			1,390	
			$ 1,800	$ 1,800

DEFERRED CHARGES

	Dec. 31, 1921	Dec. 31, 1922	Decrease	Increase
Unexpired insurance	$ 300	$ 315		$ 15

SUMMARY

Increase in working capital	$ 1,390
Increase in deferred charges	15
Increase in working capital and deferred charges	$ 1,405

The possible complications which may be met in the preparation of the statement of application of funds, are almost innumerable. Depreciation may have been credited to an asset account, thus writing it down; at the same time additions may have been charged to the asset account. The net change in the balance of the asset account ought to be broken down so as to show the depreciation as an addition to the profits, and to show the addition to the property as an application of funds.

If extraordinary repairs have been charged against a depreciation reserve, the net change in the balance of the depreciation reserve will be the difference between the depreciation and the extraordinary repairs. Adjustments ought to be made in the working papers to break down the two elements of the change in the reserve, showing the depreciation as an addition to the profits, and showing the extraordinary repairs as an application of funds.

If the profit-and-loss statement shows a loss for the period, the transfer of depreciation provisions and other non-fund-requiring expenses to the profit section, may change the loss into a profit. If the adjustments are not sufficient to change the loss into a profit, the question arises as to the proper method of showing the loss in the statement of application of funds. There are two possible methods. In the first place the loss may be shown in the funds applied section on the theory that the funds provided from other sources were used in part to cover the loss. In the second place the funds provided section may be added and the loss may be deducted in order to determine the net funds provided during the period.

When the working capital has increased, the increase is shown as an application of funds. If the working capital has decreased, the decrease may be shown as one of the sources of funds, on the theory that funds were taken out of working capital in order to accomplish the various purposes shown under the funds applied heading.

Many accountants feel that if some current item has changed in a very large amount, this change ought to be set out as a separate item in the statement of application of funds. To illustrate, assume that the balance-sheet at the beginning of the year showed a large liability on bank loans; at the end of the year this liability has been paid off. Should this reduction in the current liability of bank loans be shown as a separate item in the statement of application of funds? Those who contend that it should be, argue that it is so important an item that it ought to be given a conspicuous presentation. While this may be true, it should be remembered that if the decrease in the current liability is set out separately as an application of funds, the change in this liability cannot also be shown in the schedule of working capital. If the schedule of working capital cannot show the reduction in the current liability, it cannot show the liability in the beginning of the year. Therefore the schedule of working capital would misstate the working capital at the beginning of the year and would also misstate the change in the working capital during the year. It seems doubtful whether the setting out of this item separately is sufficiently important to justify a serious misstatement in the schedule of the working capital.

The following problem from an American Institute examination is given in order to illustrate further the preparation of the working papers and the statement of application of funds:

Following are the balance-sheets of the Alhambra Trading Company at stated dates:

Assets	Dec. 31, 1920	Dec. 31, 1921
Land	$ 3,000	$ 4,000
Building	6,000	7,500
Delivery equipment	900	700
Store fixtures	1,200	1,250
Merchandise inventory	7,500	8,650
Accounts receivable	3,200	2,400
Notes receivable	800	750
Cash	675	405
	$23,275	$25,655

Liabilities		
Mortgage notes	$ 4,000	$ 3,000
Accounts payable	7,320	6,135
Reserve for depreciation—building	600	750
Capital stock	10,000	12,000
Surplus	1,355	3,770
	$23,275	$25,655

The statement of surplus appears as follows:

Balance, December 31, 1920		$ 1,355
Add: Write-up of land		1,000
Net profit for the year		2,915
Total		5,270
Deduct: Stock dividend	$ 500	
Cash dividend	1,000	1,500
Balance, December 31, 1921		$ 3,770

Depreciation was provided during the year as follows:

Building (credited to reserve)	$ 400
Delivery equipment (asset written down)	300
Store fixtures (asset written down)	200

A new roof was put on the building, and other extraordinary repairs were made at a total cost of $250.00, and charged to the reserve for depreciation. The mortgage notes are due serially, in annual amounts of $1,000.00.

Prepare a statement of resources and their application.

THE ALHAMBRA TRADING COMPANY
Statement of Application of Funds—Working Papers

	Dec. 31, 1920	Dec. 31, 1921	*Year's excess* Debits	*Year's excess* Credits	*Adjustments* Debit	*Adjustments* Credit	*Working capital* Increase	*Working capital* Decrease	*Funds* Applied	*Funds* Provided
Land	$ 3,000	$ 4,000	$ 1,000			$ 1,000(a)				
Building	6,000	7,500	1,500						$ 1,500	
Delivery equipment ...	900	700		$ 200	$ 300(f)				100	
Store fixtures	1,200	1,250	50		200(g)				250	
Merchandise inventory..	7,500	8,650	1,150				$ 1,150			
Accounts receivable	3,200	2,400		800				$ 800		
Notes receivable	800	750		50				50		
Cash	675	405		270				270		
	$23,275	$25,655								
Mortgage notes	$ 4,000	$ 3,000	1,000						1,000	
Accounts payable	7,320	6,135	1,185				1,185			
Res. for dep'n—building	600	750		150	400(e)	250(h)				
Capital stock	10,000	12,000		2,000	500(c)					$ 1,500
Surplus	1,355	3,770		2,415	1,000(a)	500(c)				
					2,915(b)	1,000(d)				
	$23,275	$25,655	$ 5,885	$ 5,885						
Funds provided by profits:										
Net profit per books						2,915(b)				
Add: Depreciation, building						400(e)				3,815
Depreciation, delivery equipment						300(f)				
Depreciation, store fixtures						200(g)				
Dividends paid					1,000(d)				1,000	
New roof and extraordinary repairs					250(h)				250	
					$ 6,565	$ 6,565				
Increase in working capital								1,215	1,215	
							$ 2,335	$ 2,335	$ 5,315	$ 5,315

THE ALHAMBRA TRADING COMPANY
Statement of application of funds
for the year ended December 31, 1921

Funds provided:			
By net profits:			
Net profits per books		$ 2,915	
Add back depreciation:			
Building	$ 400		
Delivery equipment	300		
Store fixtures	200	900	$ 3,815
By issue of stock			1,500
Total funds provided			$ 5,315
Funds applied:			
To increase in fixed assets:			
Building		$ 1,500	
Delivery equipment		100	
Store fixtures		250	
New roof and extraordinary repairs to building		250	$ 2,100
To payment of mortgage serial note			1,000
To payment of dividend			1,000
To increase in working capital (per schedule)			1,215
Total funds applied			$ 5,315

SCHEDULE OF WORKING CAPITAL

	Dec. 31, 1920	Dec. 31, 1921	*Working capital* Decrease	Increase
Current assets:				
Merchandise inventory	$ 7,500	$ 8,650		$ 1,150
Accounts receivable	3,200	2,400	$ 800	
Notes receivable	800	750	50	
Cash	675	405	270	
Total current assets	$12,175	$12,205		
Current liabilities:				
Accounts payable	$ 7,320	$ 6,135		1,185
Working capital	$ 4,855	$ 6,070		
Increase in working capital			1,215	
			$ 2,335	$ 2,335

May and Galloway, 805 W. R. Rust building, Tacoma, Washington, announce the admission to partnership of John G. Thorstenson.

Arthur A. Lechner announces the opening of an office at 110 West 40th street, New York.