Accounts of Cotton Hosiery Manufacturers

By A. A. Piper

It seems necessary to state at the outset that the writer will not make any effort to take up every ramification of an audit of cotton hosiery manufacturers' accounts, but only items of interest to accountants who are unfamiliar with this trade which may be said to be peculiar to these institutions. Such knowledge should materially assist the practitioner when he is called upon to audit the accounts of these concerns.

The work of these factories consists in converting the raw cotton yarn into finished hosiery of varying grades, colors and sizes. The usual factory departments are:

1. Knitting.
2. Looping.
3. Inspecting and mending.
4. Fleecing.
5. Dyeing.
6. Bleaching.
7. Boarding and pressing.
8. Finishing.
9. Paper-box factory.
10. Packing and shipping.

The departments vary, depending upon the size of the plant, type of machinery, etc. Quite often the paper boxes in which the hosiery is packed are purchased from outside manufacturers instead of being manufactured by the concern itself. Some firms also have their own spinning mill, where they make at least a part of, if not all, the cotton yarn used in manufacturing the hosiery.

The selling department of the business is usually in charge of agents who have their main offices in New York. They employ their own traveling salesmen and are paid a percentage of the net sales as a commission.

Accounts Receivable

It is not unusual for sales to be made with a certain allowance for freight charges in addition to the customary cash discounts allowed for prompt settlement. The amount of the allowance is always computed as a certain percentage on the weight of the shipment and not on the sales price. In case of concerns at a distance it is made so as to compete with concerns in closer proximity to the purchaser in order to give him as low or a lower freight rate than that of competitors. These allowances in the aggregate are often quite large and make an appreciable difference in the amount of the receivables which can be expected to be realized in cash. If the accounts fail to reflect any allowance, it can very readily be ascertained if any are to be made by an examination of the orders on file.

The auditor must be especially careful to detect any shipments which have been made subject to the approval of the customer and have been treated as regular sales in the accounts. It might be claimed that it would be perfectly proper to treat these shipments as regular sales and in event of their return to handle them through the return-sales account. It must be noted, however, that "an option to purchase if he likes is essentially different from an option to return if he should not like." (*Pence v. Carney*, 78 Ark. 123.) As a large quantity of seconds is sometimes shipped in this manner, the best practice seems to be to charge them to accounts that more clearly indicate their correct status. When it is definitely ascertained that the shipment will be accepted it can be charged to the customer's account. Quite often the goods are not accepted, and in that event the freight charges must be paid both ways. All past-due accounts should be carefully scrutinized and an investigation should be made to see whether or not the merchandise has been sent "on approval." Almost the only way in which an auditor could detect such shipments would be by unusual terms, deferred payments or the acknowledgment of the officer in charge.

It will sometimes be found that shipments which have been made during the first few days after the close of the fiscal period have been included in the current sales. This is a favorite practice with some concerns and the argument often advanced is that the car was partly loaded before the close of the fiscal period. The railroad bills-of-lading will furnish the exact date of the shipments.

Inventories

Few concerns have accurate cost systems in use, and the majority have none at all. The methods of valuing the inventories of work-in-process and finished goods is, therefore, an arbitrary one and either good or bad, depending upon the knowledge of the officer under whose authority it is priced. As much of the work is performed by automatic machines, with operations clearly separated by departments, the proper distribution of the factory overhead is not so complicated as it would seem.

A method of verifying the raw material inventory of cotton yarn, which can be used to advantage when the concern under audit does not manufacture many different styles, is to compare the production with the amount of yarn said to have been used. As the management usually knows how much yarn it takes to make a dozen pairs of hose of a given grade and size, the auditor can use this method in verifying the quantity on hand, if the amount stated seems unreasonably large. In using this method, however, an allowance will have to be made for spoilage.

As the work progresses through the factory a certain amount of waste (spoilage) accumulates. In the knitting department a machine may break a needle and a whole stocking be spoiled before the operator discovers the defect. In the looping department the hose is cut down to the seam and sewed up, with resultant waste. Since most concerns have a yearly contract with upholstering or similar firms for the sale of this waste material, it has a readily ascertainable value, although it is often left out of the inventory altogether. The auditor of course must demand that it be included, and, if no inventory has been taken, he must insist that one be made. If the audit is performed subsequent to the close of the fiscal period, deductions can be made for the estimated accumulation since that date. The item is mentioned here because it is the practice of some concerns to accumulate the material until a car-load lot can be shipped so as to effect a saving in the freight charges. In such cases the omission from the inventory would make a considerable difference in the final net profits for the period.

The auditor will sometimes find that merchandise received during the latter part of the month and the corresponding liability have been omitted from the inventory. As all concerns will be found to have either a receiving department or some other method of recording the receipt of merchandise, supplies, etc., the comparison of the vouchers with such records will detect any omissions.

Containers

In purchasing aniline oil, acids, etc., the containers are charged to the purchaser at stated prices on the invoices and credits are given for the returns as made. The auditor of course should see that these containers are included in the inventory. It would not be correct to show the value of those on hand as a deduction from the liability on accounts payable as the invoices must always be paid when due, regardless of the number of containers on hand. The deductions can be made properly when the credit memorandum has been received.

Purchase Contracts for Future Deliveries

An item of great importance, especially in an audit for credit purposes, is the question of contracts for future delivery of raw materials. Contracts are made on a yearly basis, often involving the expenditure of hundreds of thousands of dollars, for the future delivery in monthly quantities of large amounts of cotton yarns, dyestuffs and chemicals. Although it is not customary for accountants to include contracts in the assets and liabilities on the balance-sheet, it is quite obvious that a banker considering extension of credit would be much interested in knowing about such items. The contracts for dyestuffs and chemicals usually contain a clause protecting the purchaser to some extent against any decline in market prices. This is not the case, however, with the contracts for the purchase of cotton yarns, and in years like 1920 manufacturers suffered heavy losses on account of such contracts. When the cotton market has declined to such an extent that a loss is inevitable, if we are to follow the accountant's rule to "anticipate no profits and provide for all possible losses" we must make some provision for such losses. On the other hand, if contracts have been placed and the market has advanced considerably the banker would like to know this fact also as it would probably be a point in favor of extending the manufacturer the desired credit. (For a detailed discussion of the treatment of purchase contracts see article by Homer N. Sweet, in the March, 1921, issue of The Journal of Accountancy entitled *Treatment of Commitments of Purchasers, etc., on Certified Balance-Sheets.*)

An examination of the contract file will give the auditor a fairly accurate idea of the amounts which the concern will have to expend monthly therefor, in addition to regular wages of employees and for miscellaneous manufacturing supplies.

Freight

For factories in the southern states, the expenditures for freight on raw materials and supplies are usually large. Often it will be found that the client has been paying the freight bills without making any effort to verify the charges, either as to rates or weight. The auditor must not pass over the freight account with the assumption that the railroad companies make no mistakes. Overcharges are frequently collected. When plants are in small cities the likelihood of overcharge is enhanced, as some of the transportation companies employ low-salaried and consequently inefficient rate and bill clerks. One case is known in which a small factory had had overcharges ranging from $200 to $300 a month, which the railroad company was forced to refund.

The auditor should inquire closely into the system of checking the freight and express bills, particularly if the concern does not have an efficient traffic manager. Every bill should be verified both as to rates and weight, and the auditor should make an examination of a sufficient number of the bills to satisfy himself that this is being done.

Practically all concerns hold membership in some local textile or other trade organization. These associations usually have efficient traffic departments and will verify the freight rates without making any additional charges. To the small manufacturer, unable to employ a clerk who has a sufficient knowledge of classifications and rates to render satisfactory service, this is particularly advantageous.

Cost Systems

It is not the intention of the writer to go into the details of cost accounting as applied to this industry, but rather to give accountants who are unfamiliar with the factory operations some idea of the conditions. At the present time much interest is expressed by the manufacturers as to the advisability of installing cost systems. Many new factories have been put into operation within the past few years, with the result that competition has been greatly increased and factory managers are realizing more and more the necessity of keeping expenses at a minimum. No doubt the auditor will be frequently asked to explain, perhaps in considerable detail, the advantages and disadvantages of a modern cost system and its adaptability to the particular company under audit.

As explained in a preceding paragraph, the factory operations are clearly separated by departments, and as the same styles of product are continually going through the same operations, it will be found that in a number of plants, especially the smaller ones, an estimating cost system, properly used, will give practically all the desired information. Besides being more simple to operate, it has the advantage of eliminating the larger expenses involved in installing and operating the more detailed cost system. An intimate knowledge of factory operations with a practical understanding of the principles of cost accounting will enable an intelligent employee to operate an estimating cost system; and this method sometimes will be more satisfactory to the management than would be the more elaborate systems which some cost accountants so ardently advocate.