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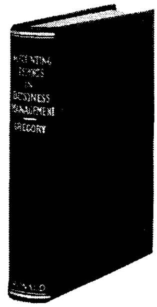

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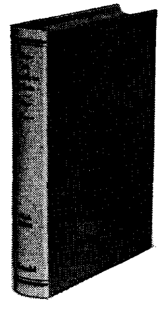

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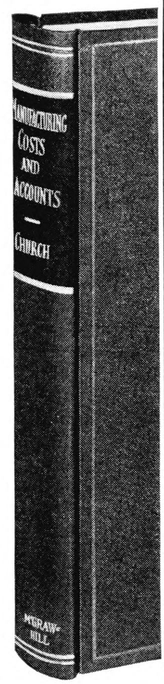

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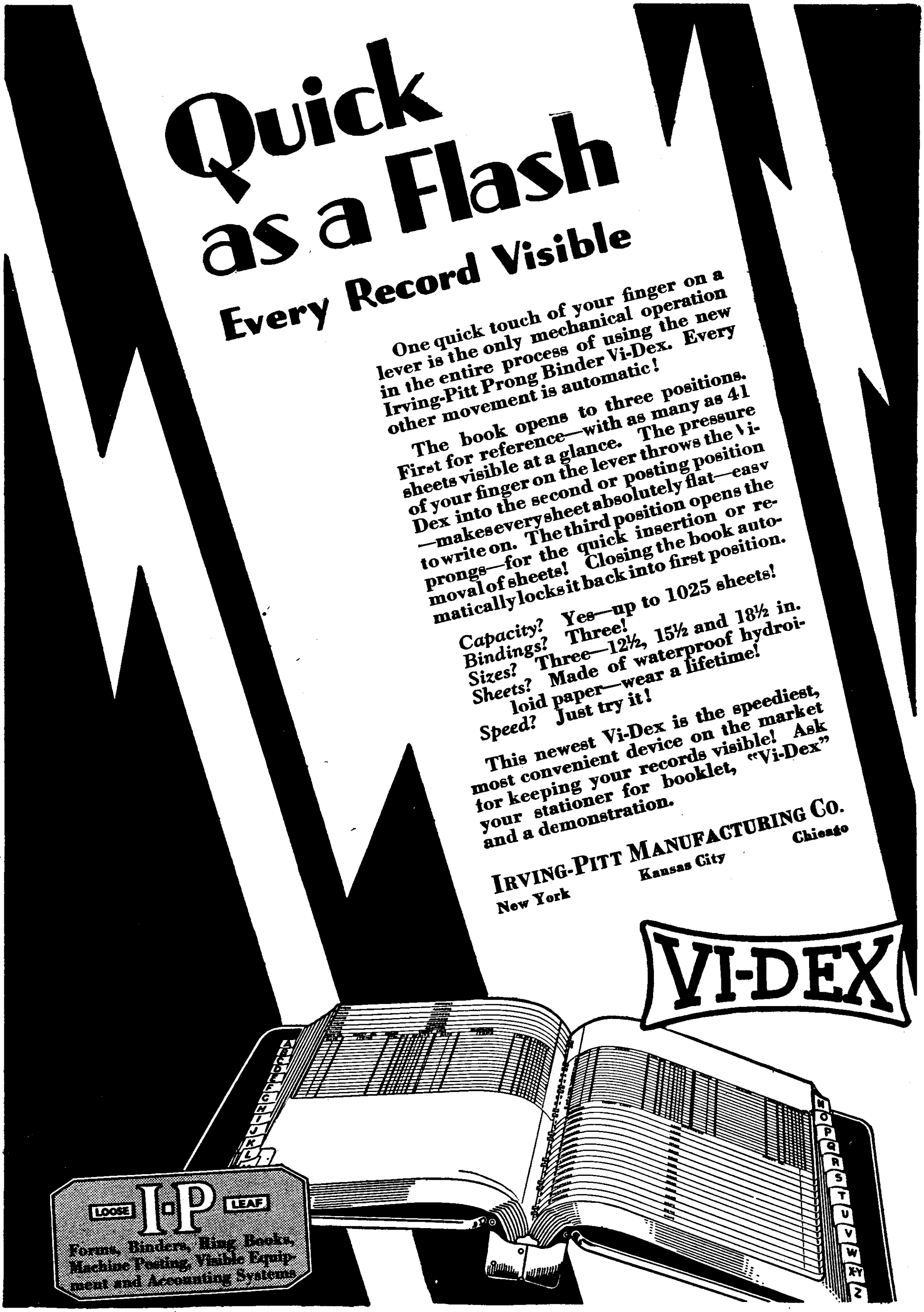
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The JOURNAL *of* ACCOUNTANCY

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The Accounts of an Investment Trust

BY HERMAN E. SCHREIBER

The choice of the subject of this paper, the accounts of an investment trust, was prompted by the fact that as far as I know no book nor magazine article has yet been published, in this country, on this particular phase of the investment-trust problem. Each of several authoritative publications on the investment trust contains a few short paragraphs on accounting problems peculiar to such companies, but none gives the necessary details—nor even an outline—for the installation of a scientific accounting system.

Today the rapidly growing number of investment trusts and the increasing size of those organizations make it imperative that adequate accounting systems be installed to take care of the large volume of business that is and will be done by them. While there were only a few small investment trusts record keeping by them was a simple matter and presented no problem. As evidence of the increasing number and size of investment trusts in this country the following figures have been compiled by an authority on investment trusts:

End of year	Number of trusts in existence	Estimated invested capital
1923	15	$15,000,000
1924	27	75,000,000
1925	48	150,000,000
1926	69	300,000,000
1927	150	700,000,000
1928 (June 30th)	199	1,200,000,000

It has been prophesied that "The day of the individual trust controlling a billion dollars of resources is near at hand."

A study of accounting practices and constructive suggestions for the solution of investment-trust accounting problems are further needed to bring about greater uniformity in accounting procedures. The lack of uniformity and the result of such lack of uniform practice will be fully shown in the section of this paper dealing with accounting problems peculiar to an investment trust.

It is the purpose of this paper not only to treat of the general principles and peculiarities of investment trusts and their accounting problems but to give to the student, the investment-trust organizer and manager, the systematizer and the auditor the details involved in the preparation of accounting forms, in the systematic recording of the business transactions, and in the auditing of the accounts during or at the close of the fiscal period.

In order to arrive at a solution of the problem of organizing a practicable system of accounting, the writer has used such information as is now available on the general subject of the investment trust. So that the reader will fully appreciate the use of the system that will be presented, a résumé of investment-trust principles, organization, management and business operations is given in the first part of this paper. In the last part the writer presents a constructive plan for investment-trust accounting based upon approved principles of accounting and auditing.

DEFINITION OF AN INVESTMENT TRUST

An investment trust is an organization of investors who have combined their funds for the purpose of purchasing a wide variety of securities, scientifically selected by skilled management; to insure safety of principal through diversification; to assure a dependable income, and to profit by capital appreciation, but without assuming a controlling interest in the companies whose securities are purchased.

The purchase of new issues and the financing of new companies is not the true function of an investment trust. That is the work of the financing company or of the investment banker.

Leland Rex Robinson gives the following definition in the *Trust Companies Magazine*, October, 1925: "An investment trust is an organization by means of which the funds of many investors, whether in large or small amounts, are jointly invested in a wide variety of securities." He has given a definition in his book, *Investment Trust Organization and Management*, in which he adds " . . . safety of principal is attained in diversification, while no control, or directive responsibilities, result from investment."

The British investment trusts conform to these definitions as well as do the true investment trusts in the United States. It must be remembered, however, that frequently, in magazine articles, in newspapers, and in various reports, holding companies and financing companies are classed as investment trusts: a clear-cut distinction is seldom made.

INVESTMENT TRUSTS DISTINGUISHED FROM OTHER BUSINESSES WHICH HANDLE INVESTMENTS

The term "investment trust" has unfortunately been used to include a great variety of organizations, both in Europe and in the United States, which are not truly investment trusts but merely perform, incidentally, some of the functions of such trusts while carrying on a banking, insurance or financing business. Some companies are frequently termed investment trusts when they are nothing more nor less than holding companies organized to control certain industrial or public-utility corporations.

There are many examples of companies which carry on an investment business but are to be distinguished from investment trusts. Holding companies, such as the Massachusetts Utilities Investment Trust, which controls a group of gas and electric companies through stock ownership, are not investment trusts because they control other companies and at the same time do not intentionally diversify their holdings. The National Public Service Corporation, The Associated Gas and Electric Corporation, and The United Light and Power Company are other examples of this type of organization. Financing companies which partake somewhat of the nature of investment trusts are those which have been sometimes called "financing investment trusts," "promoting investment trusts" and "Continental investment trusts." They can be readily distinguished from true investment trusts in that they more or less intimately control the enterprises in which they invest. It is their chief purpose to bring about the success of their subsidiary operating companies.

Insurance companies, trust companies and banks use a large portion of their funds in investing in securities of other companies, but their functions are varied. They do not restrict their operations to the business of investing for the benefit of the stockholders.

One other type of company which requires mention at this point is the "stock conversion", "trustee certificate" or "bankers share" company. Dr. Robinson formerly treated this type as not belonging to the investment-trust group, because it is not an active organization. (In his article in the *Proceedings of the*

American Institute of Banking, June, 1928, he classifies this type as a "unit series type of investment trust.") The portfolio, in this type of trust, can not be changed by the organizers nor by the trustees. Such a company resembles an investment trust in that the holdings may be diversified, in that the holdings do not represent a controlling interest in any company whose securities it owns and in that the chief purpose of the business is to invest for the benefit of the shareholders. The chief difference lies in the inability of the management to realize capital profits by taking advantage of market trends, which a skilled investor or a general management investment trust would do.

Diversified Trustee Shares is an example of the conversion trust, while the International Securities Corporation of America and the Second International Securities Corporation are examples of Dr. Robinson's general management investment trusts.

Both these types of trusts, as well as certain financing and holding companies, are classified in financial and daily newspapers under the one heading—investment trusts. This plan is usually followed by *The Annalist*, *Commerce and Finance*, *Bank and Quotation Record*, *New York Herald-Tribune* and *The Wall Street Journal*. The *New York Times* lists the holding and financing companies in the investment-trust column but under a special subheading. *The Journal of Commerce* and the *New York Evening Post* use four divisions under the general heading of investment trusts—general management, specialized management, fixed or limited management, and holding and financial companies. It is not the purpose of this paper to decide just where the line of demarcation between investment trusts and other companies closely resembling investment trusts shall be drawn. It seems that it would be quite proper to include under the name "investment trusts" all organizations conforming to the definition given at the beginning of this paper, which does not describe specifically the method to be employed in managing the portfolio.

THE PRINCIPLE OF DIVERSIFICATION

The greater the number of securities owned, if they have been chosen with reasonable care, the greater is the chance of avoiding loss on the whole, and at the same time the greater is the chance of averaging a liberal income from both dividends and market appreciation. The investor who buys 50 different securities, wisely chosen, has 50 chances to make a profit while the one who invests in only one security has only one chance. Statistics show that a certain number of securities considered good at a given time eventually depreciate in value, cease paying dividends, and even become worthless, while the average of a large number of securities would show a substantial profit to the investor owning an equal number of each of these securities. Diversification of investments is one method of applying the law of averages. With scientific selection of securities which seem certain to pay substantial dividends and to show, over a period of time, considerable market appreciation the law of averages operates by making certain a resulting substantial profit on the whole.

The investment trust, through the accumulation of funds from a large number of investors, may diversify to a much greater extent than is possible for the average investor with a limited amount of capital, a limited amount of time to study securities and a limited amount of scientific knowledge of investment conditions. The investor in investment-trust shares is thus enabled to "place his eggs in more than one basket even though he has only one egg."

European investment trusts generally invest in from 100 to 1,000 different securities originating in different industries in many different countries. They place no restrictions upon the management except as to the proportion of the capital which may be placed in the securities of an enterprise or a geographical subdivision.

The Investment Trust Corporation, Limited, according to the directors' report for the year ended May 1, 1928, has 632 investments distributed as follows:

	Percentage of valuation
British government securities	4.4%
Railways, including street railways	29.3%
Telephone, gas, electric lighting and other public works	15.4%
Commercial and industrial	27.5%
Trust companies, etc.	8.6%
Foreign government and municipal loans	9.6%
Steel, coal and iron	5.2%
	100.0%

An ideal distribution of investments is maintained by the International Securities Corporation as shown by its report of November, 1927.

According to territorial distribution the portfolio showed:

United States and possessions	29.789%
British Empire	1.873%
Central and South America	7.629%
Continental Europe	57.412%
Asia	3.297%
Total	100.000%

According to type of securities the portfolio showed the following classification:

Bonds	
Governmental	37.519%
Transportation	3.310%
Public utility	8.791%
Industrial	13.578%
Agricultural bank	7.755%
Commercial bank	3.522%
Land association	2.326%
Extractive industries	1.716%
Total bonds	78.517%
Preferred stocks	
Transportation	0.376%
Public utilities	0.528%
Industrials	2.104%
Banks and trust companies	0.002%
Investment organizations	0.197%
Extractive industries	0.046%
Total preferred stocks	3.253%
Common stocks	
Transportation	0.335%
Public utilities	0.101%
Industrials	1.009%
Banks and trust companies	1.370%
Insurance companies	0.003%
Extractive industries	0.296%
Total common stocks	3.114%
Other funds	
Bankers' acceptances	0.031%
Treasury notes	3.860%
Cash	11.225%
Total other funds	15.116%
Grand total	100.000%

CLASSIFICATION OF INVESTMENT TRUSTS

In Great Britain we find two general classes of investment organizations listed as investment trusts:

1. Those which act as financing, holding and promoting companies, and
2. Those which restrict their activities to investment of funds in seasoned securities.

They have been classified by American writers in various ways, four of which are outlined below:

I. Classified as to groups—
   1. Groups of professional investment-trust managers, whose interests entirely center in this field.
   2. Firms of investment consultants, who operate investment trusts in addition to their investment advisory work.
   3. Issuing and investment banking houses which have gone into the investment-trust business.
   4. Banks and trust companies and their associated security companies.

II. Classified as to capital set-up—
   1. "Fixed" or "limited management" investment trusts, which raise capital by issuing certificates.
   2. Management investment trusts which issue only shares.
   3. Management investment trusts which issue more than one class of security.

   Or,
   1. Statutory trust, which owns the portfolio of the trust.
   2. Contractual trust, whose portfolio is owned by the certificate holders.
      (a) Fund trust, whose portfolio is owned in common by the certificate holders.
      (b) Unit share trust, where the portfolio consists of identical units.

III. Classified as to legal forms—
   1. Corporate form of trust, which operates under general state incorporation acts.
   2. Trust indenture form, which appoints a trustee who issues trust certificates for the securities deposited with him.
   3. Massachusetts Trust form, which operates as a common-law trust.

IV. Classified as to nature of portfolio—
   1. Bonds.
   2. Stocks.
   3. Stocks and bonds.
   4. Limited diversification
      (a) As to territory.
      (b) As to industry.

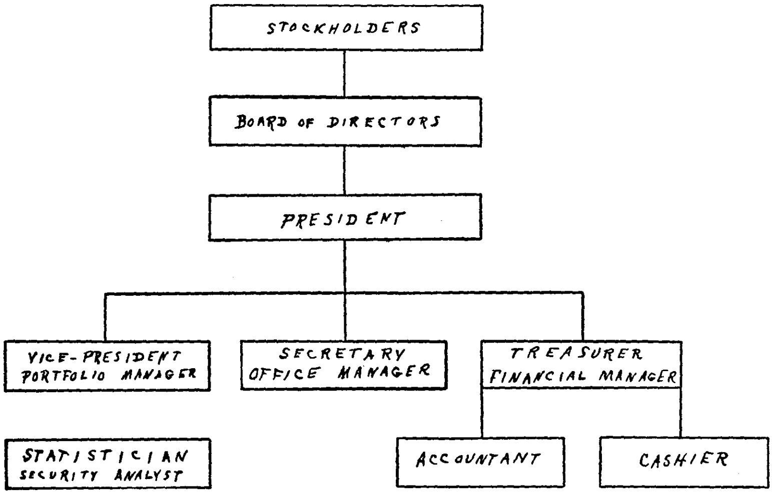
ORGANIZATION

The suitability of a plan of organization depends upon the specific type of investment trust and upon the extent of its operations.

An ideal organization is outlined in a booklet of the International Securities Trust of America, "Five years of growth and progress." This plan of organization would be suitable for an investment trust which is international in scope and is doing an enormous volume of business. On pages 169 and 170 are reproductions of charts outlining the general organization and the detail of the administrative departments.

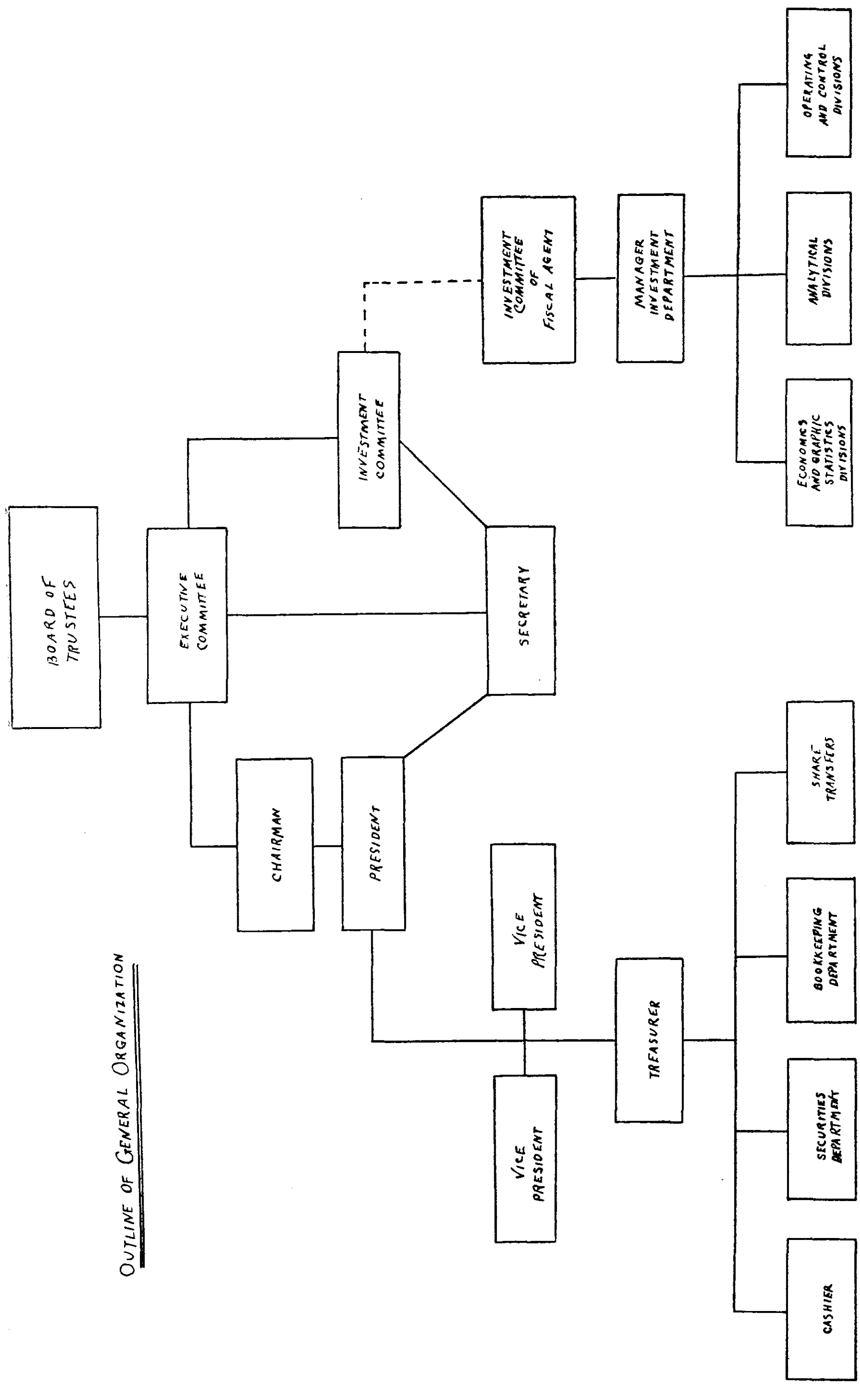
Investment trusts which depend entirely upon outside investment services need not maintain statistical organizations. The organization chart of the International Securities Trust of America provides for a complete organization, but shows that the statistical department is maintained by the fiscal agent.

A simple plan of organization is shown below. As it is possible of infinite expansion it is ideal for a growing organization. It may be adapted to either a small or a large concern.

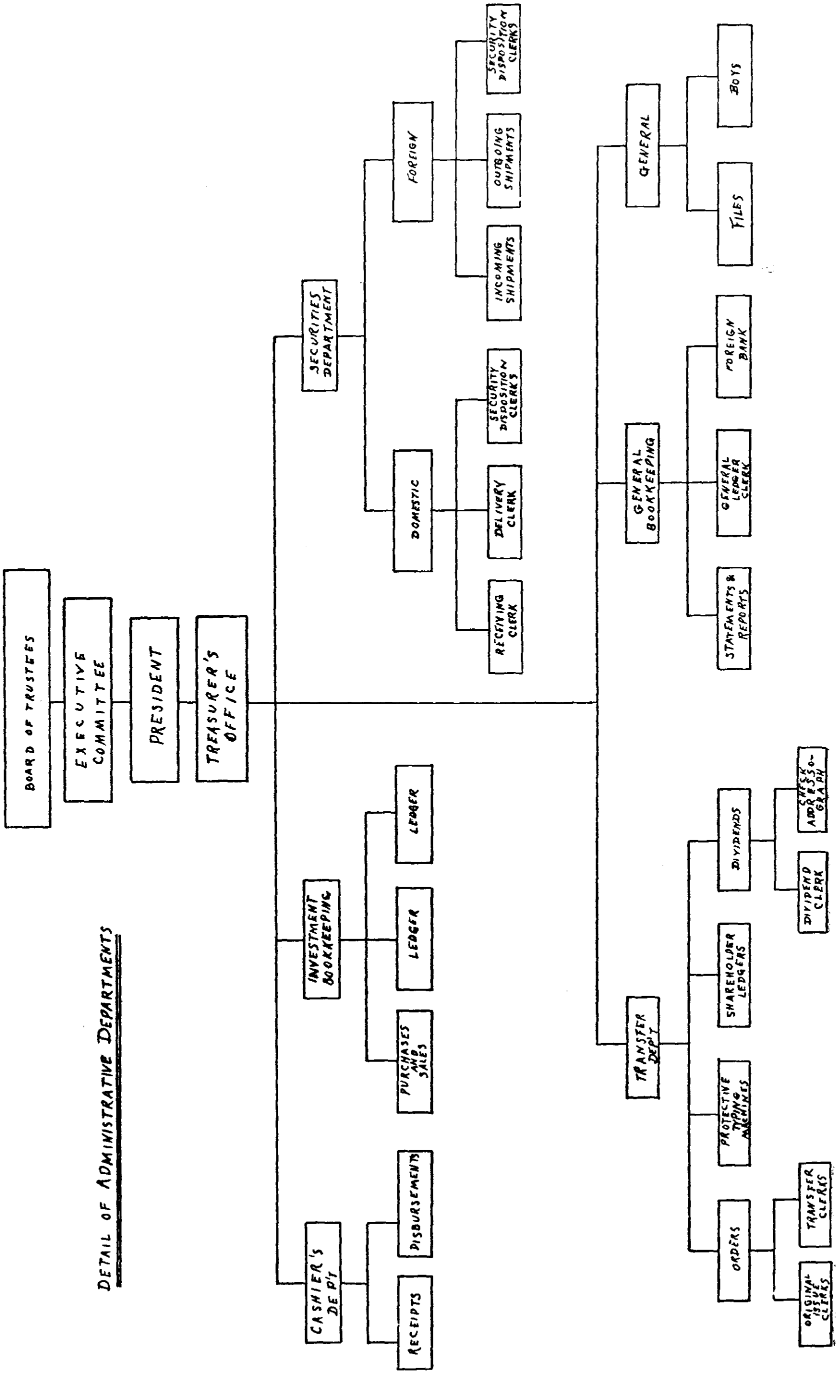


MANAGEMENT

British experience has taught that the secret of successful management lies in the judicious adjustment of the portfolio in accordance with market conditions. Therefore, within certain



OUTLINE OF GENERAL ORGANIZATION



DETAIL OF ADMINISTRATIVE DEPARTMENTS

limitations, the directors are allowed to manage the portfolio according to their own judgment by buying and selling at such times as they believe such action is advisable for the best interests of the trust. The earlier trusts were so conservatively managed that they were able to pass through periods of depression without passing dividends. They built up large reserves—mainly secret reserves—so that the securities held were able to stand a great amount of market depreciation without resulting in the impairment of capital. Management has been independent of banking and financing institutions so that the directors and managers of the portfolio have not been influenced by interests other than the success of the trust with which they are charged. Accountants and lawyers have usually been chosen to manage the trusts.

We find in the United States a variety of management organizations and management policies. In the trust form of organization the trustees are charged with the management, while in the corporation form the burden of management is placed upon the directors. Bankers, brokers, accountants and financial advisors are usually appointed to manage our investment trusts.

The duties, rights, restrictions and limitations of the managers of the portfolio are usually specifically set forth in the instrument which establishes the trust.

The management of trust funds should accomplish three purposes: (1) safeguard the principal against loss, (2) make income certain and regular, and (3) increase the income or principal or both.

The weakness or the strength of the trust depends upon the management upon whose shoulders falls the burden of properly selecting and changing securities for the portfolio.

RAISING OF CAPITAL

The British investment trusts raise capital by selling ordinary and preferred shares and debentures. There may be several kinds of each of these. At the present time about one third of the capital is raised by the ordinary shares while the remainder is raised by preferred shares and debentures. The increasing cost of money tends to reduce the amount of borrowed capital. The par value of the stock is kept low to attract the small investors. The preferred stock is usually cumulative, non-participating and preferred in other respects over ordinary shares, and pays dividends from 4 to 5½ per cent.

The articles of association always limit the amount of capital to be raised by the issue of debenture stock. Other forms of borrowing are seldom used. The debenture stock has an advantage over collateral trust bonds in that the former permits the issuing company to change its investments—the lien on the investment securities being a floating one.

Increments to capital are generally obtained in flotations in lump sums at stated times.

A few British investments trusts are listed below to show their capital structure. (Taken from *Handbook for Investors*, F. C. Mathieson & Sons, 1928):

Company	Outstanding stock (1928) Deferred or common	Preferred	Debenture
Alliance Investment	$200,000	$600,000	$302,695
American Investment and General	750,000	750,000	750,000
Army and Navy Investment	200,000	360,000	*400,000
Bankers' Investment	900,000	900,000	*900,000
British Investment	900,000	1,350,000	1,633,550
British Steamship Investment	1,800,000	300,000	*200,000
Foreign and Colonial Investment	1,550,000	....	1,250,000
Guardian Investment	500,000	500,000	*500,000
Investment Trust Corporation	1,250,000	1,875,000	2,000,000
Rubber Plantations Investment	2,250,000	....	....
United States Debenture Corporation	525,000	1,050,000	1,207,500

*Perpetual debenture stock.

Two methods of raising capital are in use: making occasional flotations, as is practised by the British trusts, or "feeding" out securities to the public as the demand will assimilate them. The latter method is quite often used in the United States because the investors are just beginning to learn the advantages of investment trusts. After the financial standing of the trust is established and becomes familiar to the public, occasional flotations will be less costly and can be resorted to successfully.

There is little uniformity in the matter of capital structure. This is largely dependent upon the character of the trust. Fixed trusts raise all capital by issuing trust shares, while the management types of trusts issue bonds, preferred stock and common stock, or only common stock.

NATURE OF THE ACCOUNTS OF AN INVESTMENT TRUST

Business transactions. The business transactions of a typical investment trust are few in number compared with those of other financial and investment businesses. The raising of capital is undoubtedly the most important of its transactions, but when this part of its business is turned over to its fiscal agent very little bookkeeping is required—the entire issue of stock is disposed of by one transaction. This now leaves the buying and the selling of investment securities and the collection of dividends on such securities as the main source of bookkeeping records to be kept by the trust. Consequently, cash is received and paid. Securities are bought and sold. About the only other class of transactions which will require the attention of the accountant in the installation of an accounting system is the incurring of expenses—the cost of operations.

Sources of income. The income is derived from five sources:

1. Interest on bonds held.
2. Dividends on stocks held.
3. Profits made in changing investments.
4. Interest on loans and bank balances.
5. Sale of stock dividends and stock rights.

These are the only sources of income of the investment trust when carrying on business only as such. Most of the British and some of the American companies carry on other lines of business in addition to the purely investment business. They may act as fiscal agents for other trusts; they may act as trustees for private estates; or they may even act as promoters for other corporations. In case such other lines of business are carried on by the trust additional sources of income will begin to appear.

Expenses. Cost of management in England in some instances may consist of a lump-sum payment for "directors' fees," or it may consist of a payment of an amount calculated as a per cent. of the capital, or the trust agreement may provide that a percentage be appropriated to defray expenses and that the remaining balance shall accrue to the credit of the directors.

The usual expenses incurred in operations are fees to trust company or directors' or trustees' fees, legal costs, auditors' fees, management expenses (management fee or officers' salaries), rent, stationery and other office expenses, office salaries, commissions and brokerage fees, taxes (income, state franchise, property, transfer), interest on loans and brokerage accounts, cost of exercising rights and miscellaneous expenses.

(To be continued)

Industrial Pensions and Wages

By John Whitmore

I

It is my purpose here to consider briefly the subject of industrial pension systems in the United States and to consider the principles involved in them and the ultimate aspects of them as far as these are discernible. I shall consider the matter rather in relation to manufacturing industry than in relation to railroads and other public utilities; and as regards manufacturing industry, at least, I shall venture to suggest that pension systems, conceived to meet a need arising out of temporary industrial conditions, ought, as industrial conditions change in ways that are already indicated, gradually to cease. At present, as far as industrial pension systems in manufacturing industry exist, they undoubtedly, in their measure, which is by no means inconsiderable, meet very real needs; and this will inevitably be true for a long time to come. The question in regard to an old-age pension for a single worker involves a working-life history, and the completing of any radical change must be a matter of many years. It seems, in fact, very desirable that in the meantime industrial pension plans, formal or informal, should be generally adopted—for the reason that they correspond to the conditions that have existed through a large part of the lives of many workers whose old age is still to be provided for—but always with a view to their ultimate termination.

Important studies and criticisms of industrial pension systems have been published in rather close succession for some years past. Luther Conant Jr.'s *Critical Analysis of Industrial Pension Systems* (Macmillan, 1922) is the earliest comprehensive work and is still of the greatest possible interest. The National Industrial Conference Board's *Industrial Pensions in the United States* (1925), partly because of its later publication, embraces in its study a still larger number of plans. The successive annual reports of the Carnegie Foundation for the Advancement of Teaching have for ten or more years past each included a critical survey of the year's progress in the matter. Of considerable interest are three articles written by Gurden Edwards, published in *The Annalist* of 1925, and reprinted by the Metropolitan Life Insurance Company under the title "Retirement plans in industry"; also the studies and proposals of the old-age pensions committee of the industrial-welfare department of the National Civic Federation (1925, 1926, 1927). In the present year there is a pamphlet published by the American Management Association under the title, "Pensions: a problem in management," which includes a paper by Edward S. Cowdrick and discussion by a number of industrialists and others with extensive pension experience. Finally, there is in progress of publication another comprehensive study by the Industrial Relations Counsellors, Inc., the preliminary report being dated May, 1928.

The first industrial pension system in the United States was inaugurated by the Baltimore & Ohio Railroad Company in 1884. There are probably at the present time about three hundred formal pension systems in force in the United States. It is calculated that about $50,000,000 per annum is being paid to about 100,000 pensioners, and that of this about one half is being paid by the railroad companies to former employees. Public utilities other than railroads and financial institutions having pension plans total over one hundred; and manufacturing industries, according to the preliminary report of Industrial Relations Counsellors, Inc., one hundred and twenty-three, of which a number are consolidations.

All industrial pension plans in the United States are in the same stream of development, and all have been treated, I think always, as parts of the same story. But I believe that, in the end, the problems they present must be considered separately, according to classes of industries.

Principally, the conditions are not the same in public utilities and in manufacturing concerns. The former, generally speaking, have greater permanency of existence, important in relation to the pension promise which from the time it begins to be in effect to its final fulfilment may spread over a period of fifty years. They have also probably something more nearly approaching general permanence of service, whereby a much larger proportion of the workers will fulfil a "length of service" requirement and so receive pensions. They have, I believe, in the last analysis, more fixed and limited standards of pay. Bonuses and profit-sharing, already existing and capable of great extension in manufacturing industry, are probably impracticable in public utilities, under government control and government regulation of rates that may be charged to the public. I am considering critically pension systems in manufacturing industry only.

While practically all writers on the subject of industrial pensions raise serious questions concerning the great majority of such systems, as to their social morality, as to their being ultimately practicable, as to their ever being effective at all on a sufficiently wide scale, it seems the fashion, especially of late, to take the need of pension systems for granted and to consider merely the advantages and disadvantages of different plans. This was not quite the position taken in the National Industrial Conference Board's work, nor in Luther Conant's *Critical Analysis*. The former says (p. 125), "It is not the purpose of this report to recommend or to discourage the establishment of pension plans in industry." The latter discusses more searchingly the economic and moral aspects of pension. Both give consideration and weight to the almost totally antagonistic attitude of organized labor.

Each of the two works just mentioned reviews the history of pension plans in the United States, and each contains an appendix classifying them. The *Critical Analysis*, published in 1922, lists 94 concerns having pension plans, and *Industrial Pensions in the United States*, published in 1925, lists 247 such concerns. About one fourth of the difference, apparently, is due to the different years of publication. It will, I think, be well to take the later and more comprehensive list.

It is seen, as I have already noted, that the earliest formal industrial pension plan in the United States was inaugurated by the Baltimore & Ohio Railroad Company in 1884. There were, altogether, five such plans up to the year 1900. From 1901 to 1910, 44 were added; from 1911 to 1915, 73; from 1916 to 1920, 68; from 1921 to 1925, 40. The maximum for a five-year period was, then, from 1911 to 1915; after that the numbers fall. This has been attributed to unsettled post-war conditions and to a growing realization of ultimate costs. I am inclined to add rising wages as a probable important cause, for I can not doubt the relationship between the question of the adequacy of the immediate wages paid to labor, and the ultimate supplementing of wages by pensions.

Pension plans are classified primarily as non-contributory or contributory, the former meaning that the employee makes no money contribution to the scheme, and the latter that he contributes regularly out of his wages to the pension fund, in whatever form this may be.

Non-contributory pension plans are further classified as discretionary and limited-contractual. Contributory plans in manufacturing industry (with the slight exception of two or three fully contractual plans) are all limited-contractual. Discretionary plans are defined as "reserving to the employer the exclusive right to grant, withhold, reduce or terminate the allowance in individual cases, or to modify or abandon the plan altogether." Limited-contractual plans are discretionary during the working-life, but pensions once granted may not be changed. And if the plan is contributory the employee is entitled in any circumstances to the eventual return of his own contributions, either with or without interest.

It seems clear that "limited-contractual" often covers some further contractual features when the plan is contributory. The employer may undertake to contribute certain sums to a joint fund. The employees may participate in the administration. The plan may in these and other ways tend to a closer understanding and mutual engagement between employer and employees. But the conditions governing the employer's contributions and the employees' contributions are still so distinct that apparently there is not here a single plan, but two plans, namely, a savings plan (the employees' contributions), and a limited-contractual pension plan undertaken by the employer. There is said to be a recent tendency to separate the funds, and to call the plans "coöperative" instead of "contributory." *

In any case, contributory plans are plainly a great advance upon non-contributory plans. The purpose is no longer merely an old-age pension for the worker himself. The benefits are no longer merely planned by others for him, but he is himself saving. The move is in the right direction. Its character is emphasized in the following quotation in the *Critical Analysis* from the seventh annual report of the Carnegie Foundation for the Advancement of Teaching:

> "In all contributory systems, experience has shown that eventually the contributors will demand four things: first, that if a contributor is dismissed or resigns voluntarily before the pensionable age, he shall be paid the amount of his total contributions, with interest; second, that if a contributor becomes disabled before the pensionable age, he shall receive

* *Pensions: A Problem in Management*, by Edward S. Cowdrick, American Management Association, 1928.

either a full or proportionate pension; third, that if he dies before retirement, his estate shall receive the amount of his total contribution, with interest, or even the amount of both his and his employer's contributions, with interest; fourth, that if he retires upon a pension, but dies before the total amount of his pension receipts equals the amount of his total contribution, with interest, his estate shall receive the balance."

An officer of one of the large consolidations in manufacturing industry having a non-contributory discretionary plan, has, however, advanced the pertinent question whether it is not better to have savings plans "that will stand on their own feet, rather than to operate them under the guise of a pension plan." I shall discuss this question later on.

There are, then, these types of pension plans in manufacturing industry: discretionary and limited-contractual, and each of these either contributory or non-contributory, and a very few contractual plans. Of the 247 plans in all industries listed in *Industrial Pensions in the United States* in 1925, 171 were non-contributory and wholly discretionary with the employer; 43 were non-contributory and limited-contractual; 20 were contributory and limited-contractual; and the remaining 13 either contractual or of some special type, but few of these 13 were in manufacturing industry.

It is presumable that in every industrial concern that has had a fairly long existence, sufficient for employees to have spent a large part of their working lives in its service and to have grown old therein, there has come a time when the management has, without any pension plan, granted some individual pensions. As concerns grow larger, and as with the lapse of time present and prospective pensioners increase in number, a formal plan apparently comes to be regarded as desirable. Probably the cost, present or prospective, comes to be seriously considered, and it is felt to be necessary to justify the expenditure on business grounds. A plan is formulated that aims to secure definite benefits to the employer in return for the pension expense. This seems to be the usual origin of industrial pension systems.

It was expected that the establishment of formal pension plans would create feelings of appreciation and increased attachment on the part of employees; that the prospect of a retirement pension would lift some anxiety from their minds; that as a result they would give more efficient service, and particularly long continuous service, reducing labor turnover. It is plain that these expectations have not been very generally fulfilled. In the later years more emphasis is placed upon the advantage of an established routine for retiring aging employees when it is desirable in the interests of the business to do so.

Except for earlier disability, and possible special circumstances, pensions in practically all cases are dependent upon two conditions, age and length of service. *Industrial Pensions in the United States* (pages 72 and 78) contains tables of retirement ages fixed and length of service required in 118 plans. Compulsory retirement ages are from 60 to 70 for men, and from 55 to 70 for women. Length of service required (with negligible exceptions) ranges over 20, 25 and 30 years. Continuity of service is insisted upon in practically all plans. Subject to the right of employees under contributory plans (of which in 1925 there appear to have been not more than ten at the outside in manufacturing industry), all service credits are canceled by resignation, discharge, or going out on strike. The right of the employer to discharge is kept intact.

Industrial Pensions in the United States says, "Nearly one half of all the plans studied fix an age limit for persons entering the employ of the concern for the first time . . . the age limit observed with by far the greatest frequency is 45 years."

The most serious questions relative to existing pension systems are concerned with their more obscure workings, and to some discussion of these I must come later. The plain conditions as affecting the employees are, in the meantime, serious enough. Louis D. Brandeis (quoted in *Critical Analysis*, p. 45) speaks of them as tending "to rob the working man of his little remaining industrial liberty." This seems scarcely an exaggeration, although no measure of his liberty is ostensibly taken away from him. He is placed in a position where perfect freedom of action can not be exercised without sacrifice. Pension systems are frankly arranged to create a penalty, which in many cases in any working force of ordinarily varying ages, must be very heavy, for going out on strike. The continuous service is broken and for many it is too late to begin again. But the hampering of the employee's freedom of action goes beyond this. He may wish to change his employment for many reasons; he may have the opportunity of securing higher wages or other better conditions elsewhere; and then he has to choose between sacrificing increased advantage in his working life and sacrificing his prospect of a retirement pension. And if he sacrifices other advantages for the prospect of a retirement pension, the latter is still uncertain. It is, in nearly all cases and at least throughout the working life, discretionary with the employer. The employee may through unforeseen causes be obliged to change his employment; he may be discharged; the employer may fail, or the company be merged with another company not willing to assume pension liabilities, as occurred when Morris & Company were merged with Armour & Company in 1922.

As regards the maximum hiring age, which apparently is an inevitable accompaniment of the pension based on fixed retirement age and length of service, and virtually of all private pension systems, it seems difficult to imagine anything more deplorable. Concerning it, a recent writer* has said, "There is this seeming paradox: the very pension systems that are designed to support old age operate against the employment of men of advanced years, since employers who pay pensions naturally expect their workmen to render service for at least reasonably long periods before reaching retirement age." The principle is just the same as if pension systems and maximum hiring ages were universal, and the man over 45 were left with the simple choice between his present job and none at all.

If there is a good deal to be said against existing pension plans from the employees' side, it seems that the employers have reason to be seriously concerned about them. Their situation is indeed drawn in very dark colors. The first of the three articles, already alluded to, by Gurden Edwards in *The Annalist*, since republished by the Metropolitan Life Insurance Company, is entitled "Industrial pension plans collapsing." Perhaps this is an extreme view, but it is difficult to see that it is very different from the conclusions arrived at by all who have considered the matter carefully.

The *Critical Analysis* (p. 2) says, "Very few of the industrial pension plans in the United States today are so financed that they are likely to remain solvent without refinancing or modification."

Industrial Pensions in the United States (p. 101) says, "The great majority of pension plans in American industry have been established with no accurate calculation of their future costs and with no adequate provision for financing them."

The Carnegie Foundation annual report, 1926, quotes two authorities. First, Matthew Woll, vice-president of the American

* Edward S. Cowdrick, *Pensions: A Problem of Management*, American Management Association, 1928.

Federation of Labor and president of the Union Labor Life Insurance Company: "Five hundred industrial institutions, among them many of the strongest in the country, are piling up obligations which will, within a few years, require very large expenditures for which no provision is now being made." And, second, the 1925 report of the Superintendent of Insurance, state of New York: "A large percentage of the existing pension systems were established on unsound bases. Bitter disappointment is in store for prospective beneficiaries under such unsound systems."

The simple fact appears to be that industrial concerns have gone into the business of deferred annuities under conditions involving risks which no insurance company would assume, and have done so in the great majority of cases without actuarial calculations of costs and without funding in due time the resources which with accumulations to the maturity of the obligations would suffice to meet them.

It seems very doubtful that even approximately accurate calculations are possible under the conditions of the great majority of existing plans. The pensions eventually payable depend upon labor turnover. Pensions are payable only to employees remaining with the concern until retirement age. The matter can not be foreseen. It is one aim of the pension plan to produce a different result from that in past experience. It aims to secure long continuous service. Next, the great majority of plans provide for a pension determined by multiplying a percentage of the average salary of the final 5 or 10 years by the years of service. The percentage is commonly 1, 1½, or 2. It is said that the wage level has risen in this country, from 1913 to 1928, 120 per cent. Pensions to be paid will therefore be something like double what might have been calculated for a plan established as long ago as 1913. Gradual adjustment would have been possible, but frequent revaluations of the accruing pension liability would have been necessary, and there is every indication that such frequent revaluations have been made in very few instances, if any.

Neither change in labor turnover, if indeed there has been any material change in this, nor change in wage level, which in the long run would come into relative adjustment, has, however, been the cause of the unsound condition, said to exist pretty generally, in industrial pension systems. The real troubles are lack of actuarial calculations and of funding; or in plainer words, ignorance of the long-continued increase and the ultimate annual burden of pension payments, and neglect of the principle that the cost of pensions, as a part of the cost of labor, needs to be accrued, year by year, throughout the years in which the labor is performed.

The way pension payments increase is illustrated in the first of the Gurden Edwards articles by three charts. The first assumes no growth in the payroll in the 30 years preceding the adoption of the pension plan. In the first year pensions commence for employees who entered the service 30 years before. Each year following the same number becomes eligible. Mortality, of course, gradually checks the accumulating numbers. The maximum is reached in 20 years and is then 12 times what it was in the first year of pension payments.

The second chart assumes an annual increase in employees of 10 per cent. for 20 years, and then no further increase in the succeeding 10 years of the 30 years preceding the adoption of the pension plan. The maximum is reached in 34 years and is then 37 times what it was in the first year of pension payments.

The third chart is said to represent conditions in an actual and well known manufacturing company. It is said that in this company pension payments, a few years after the installation of the plan, were becoming heavier than had been expected or provided for, and that an analysis of the situation revealed an inevitable burden which the company's finances could not support, and that abandonment of the pension plan was recognized to be imperative.

It seems plain that nothing but actuarial calculations can give any idea of the ultimate liabilities.

It is variously calculated, however, that from 1 per cent. (Gurden Edwards' second article) to 2 or 2½ per cent. (*Critical Analysis*, p. 150) upon current payrolls throughout the employees' service period, invested currently in interest-bearing securities, would yield reasonable pensions. These figures contemplate no withdrawal or death benefits; in other words, they take the full advantage of labor turnover and mortality. The actual pensioners are, of course, relatively few.

The relation between the amount necessary, if funded year by year throughout the working life, and the amount of the ultimate pension (considering individual cases singly) is shown in the Gurden Edwards articles by the following examples:

1. Salary $1,000. Employed at 25. Pensioned at 65.
   1% × 40 years = $400. Expectancy of life 11 years = $4,400.
   Reserve of $38.45 per annum throughout 40 years with 4% interest accumulations would provide for above.

2. Salary $1,000. Employed at 30. Pensioned at 65.
   $500 pension for 15 years.
   Reserve of $75 per annum throughout 35 years with 4% interest accumulations would provide for above as follows:

Annual contributions	$2,625.00
Interest—contrib. period	3,168.00
" annuity period	1,753.00
	$7,546.00

But in addition to the actual financial difference, there is the accounting difference. If the necessary percentage of each year's payroll is funded immediately, it is an immediate charge completing the cost of the year's labor in the year's accounts. If no sufficient reserve is made currently, it is always left for future years to complete the payments in remuneration of this year's and every year's labor. The question has been raised, quite fairly it seems to me, whether the balance-sheet of a concern having a pension system in operation is correctly stated unless the accrued pension liability is stated with whatever accuracy is attainable. It has been estimated (though not in a manufacturing industry and therefore probably not with the benefit of the same labor turnover) that accrued pension liability may equal a year's payroll (*Critical Analysis*, p. 174).

Whatever the amount of the accrued pension liability at a given date, and assuming that the pensions are ultimately to be paid according to the plan, by that amount past production costs have been understated, and the future (except as some provision may have been made either by separate fund or reserve in the accounts) left to bear an expense for which it will be receiving no return.

Industrial Pensions in the United States (p. 111) has a table, "Actuarial control and funding," which contains the following:

Plans reported as actuarial	36
" " " non-actuarial	177
" " " funded	85
" " " not funded	136

"Reported as actuarial" might mean anything from some actuarial calculations to continuous actuarial control; and "reported as funded" would doubtless include all having any pension fund whatsoever.

[A second article on industrial pensions and wages, by Mr. Whitmore, will appear in a subsequent issue of THE JOURNAL OF ACCOUNTANCY.—*Editor.*]

Appeals from Claim Rejections

By Hugh C. Bickford

The suggestion has been made that the jurisdiction of the board of tax appeals be enlarged to enable it to pass upon suits for the recovery of taxes, in addition to its present power to review determinations of deficiencies as made by the commissioner of internal revenue. The thought has a parental wish. Obviously, the wish is that there be some judicial body with authority to review decisions of the commissioner in cases where his view is considered erroneous and it is found, due to the particular status of the case, that the board does not have jurisdiction.

The suggestion should be carefully weighed. When one finds a tribunal with over twenty thousand unheard cases on its docket and learns, as a result, that his case, when filed, must wait for several years before it is tried, and even longer before it is decided, one must express some doubt as to the wisdom of increasing the business of that tribunal and further submerging its functions beneath the flood of a new class of cases. The fact remains, however, that this board can not review many decisions of the commissioner, such as rejections of claims for refund, and that these decisions are as likely to require review and correction as those which result in deficiencies and may, therefore, be carried to the board. The fact which is too generally ignored is that there is ample opportunity of reviewing the commissioner's actions on refund claims without going to the board. The writer refers to review by the federal courts. This right existed before the board was established and if it had been resorted to more frequently probably would have made unnecessary the creation of the board in the first instance.

Before the creation of the board there was not one case in many thousands which reached the courts. Yet, at that time, the commissioner was handing down the same decisions which are being made today, with the same, if not a greater degree of inaccuracy than that which now prompts the filing of so many petitions with the board. True, there was no mode of obtaining relief until after the tax was paid but even this relief was not often sought because of the generally prevailing hesitancy to go into court.

The effect of the creation of the board upon tax practice has been marked in many respects, but in none so plainly as in the effect upon those who represent taxpayers. They now unhesitatingly turn to the board for the courtlike relief which it affords, and, in so doing, they have learned the magic of sworn testimony and documentary proof, properly presented, and of logical argument, timely made. They have learned that public decisions based upon a public record are rather less arbitrary and infinitely more satisfactory in ultimate result. Strangely, however, there is still the same hesitancy to seek the relief which the courts afford and still the same ungrounded fear of suits for recovery.

One sometimes wonders if the hesitancy was or is caused by the fact that tax representatives, generally, are not trial lawyers, and reach the conclusion that if the case is carried into the courts it will mean that they will have to relinquish its control. The thought is too repugnant to bear emphasis. Surely, no professional man, whether he be an accountant or office lawyer, would be guilty of restricting the rights of his clients to the limits of his own capabilities.

The writer does not wish to enter the dog-eared discussion as to which is best qualified to handle a tax case—the accountant or the lawyer. He sometimes thinks that one must be both; and, likewise, an economist, a statistician, a paragon of patience, yea, even a psychologist, for else how could one know just the proper time to admire the cravat of the conferee? Undoubtedly, however, there is need at times for the British system of the divided sphere of solicitor and advocate. When the solicitor has conducted, out of court, all negotiations and conferences seeking to obtain for his client a just settlement, and has failed, it is his duty, in a proper case, to recommend trial and to arrange for the advocate, or barrister, to conduct the trial of the case. So, in tax cases, when the accountant, or office lawyer, has exhausted all proper means before the department and has failed to obtain that which it is honestly believed his client is justly entitled to, it is his duty to advise his client of his right to recover by court action and to bring to that proceeding, in an advisory capacity, the knowledge and experience which he has derived from the negotiations before the department. Otherwise, the representative has failed to apprise his client of his full remedy and has subjugated the rights of the cause to his own limitations.

For example, some months ago there was a case pending before the treasury department involving the valuation of a patent. The inventor had conducted the business of manufacturing the patented article as a sole proprietorship for seven years. His inventive genius was far superior to his business sagacity and the company lost money in virtually every year. Finally, a corporation (let us steal the department's custom and call it the M Company) was formed and the patent, together with all other assets of the business, was paid in for capital stock. Stock having a par value of two million dollars was issued for the patent, and the M Company subsequently claimed as deductions from gross income the amortization of that amount. The department applied its well known formula, based solely upon earnings, and held the patent to be worthless with the result that the entire deduction was disallowed. Affidavits were obtained from several nationally known experts in the art who testified that in their opinion the patented article was the best of its kind in the world—a distinct and highly valuable contribution to commerce and to science. Hundreds of original letters were exhibited which contained orders for the article which had not been filled because of the limited facilities of the business as it had been conducted. Finally, several business men of the community executed affidavits that several months before the incorporation of the business they had offered one million dollars for the patent and had been turned down by the proprietor, and, further, that they had agreed among themselves to pay two million if they could get the patent. Spokesmen of the unit said they "didn't know these men; they didn't know whether they *had* two million dollars; they didn't know whether they would have given it if they had had it." (Any tax representative knows the rest of their answer.) Affidavits were filed by prominent bankers testifying that the men making the offer were the wealthiest and best type of men in the community (character witnesses). Finally, letters were filed from members of congress from that locality testifying to the honesty and reputation of the bankers and of the offering syndicate. The unit continued to point out that the patent had never produced any actual profits, but finally yielded sufficiently to allow a value of one million dollars. The case was carried into court. There the same witnesses were called. Their testimony was convincing and the government offered no rebuttal. It was not necessary there to bring in a second group of witnesses to prove that the first witnesses were not liars and a third group to prove that the second were honest. The two-million-dollar valuation was allowed. A hesitancy to go into court in this case would have cost the clients many thousands of dollars.

Still another illustration. A partnership claimed special assessment under section 210 of the revenue act of 1917. The partnership was a commission house and argued that it had done over six million dollars' worth of business for its clients on a capital of only $16,000. It kept no books of the total business handled but only of the net commissions received. By consistent rule of the trade such commissions were paid at the rate of one and one-quarter per cent. of the business handled and amounted to $75,000 for the taxable year. Capitalizing this amount, the figure of $6,000,000 was easily obtained. The department refused to believe that $75,000 in commissions meant a total business handled amounting to $6,000,000. One representative in the department went so far as to intimate that inasmuch as that figure was not on the books, somebody must be fabricating. Affidavits, briefs, protests, photostats of the books and all other evidence requested were filed with the department, but the claim was rejected. The case was carried into court where the same evidence was presented which had been exhibited to the department. The government's arbitrary opinion was not competent evidence. The court specially found the facts without question. A hesitancy to go into the courts in this case would have cost the client considerable in taxes which he did not legally owe. The illustrations could be presented ad infinitum. The point is that there should be no such indecision, in a proper case, to claim a right which the law gives. The answer in such cases lies in the courts.

To place one in the proper position to advise court action and to arrange for its commencement, it is necessary to know the remedies provided. The principal class of cases will be those in which the taxes have been paid and claims for refund rejected. Before suit may be brought for the recovery of such taxes all of the prerequisites established by law must have been observed. It must be borne in mind that the sovereign may not be sued without its consent, and, if it has attached purely formal conditions to its consent to be sued, these conditions must be complied with. As Mr. Justice Holmes has stated: "Men must turn square corners when they deal with the government." The conditions to be fulfilled before suit may be commenced are contained in section

1113 of the revenue act of 1926, amending section 3226 of the *Revised Statutes*. Briefly stated, they are:

1. The tax must have been paid.
2. Within the statutory period of limitations a proper claim for refund must have been filed.
3. The claim for refund must have been rejected, or, if not rejected, must have been pending before the commissioner for at least six months.
4. The suit must be brought within five years from the date the tax was paid or within two years after the claim was rejected.

Numerous decisions have been made involving these conditions, the most important of which are to the effect that the claim which forms the basis for the suit must be a proper claim for refund or credit. A claim for abatement or an informal claim is not sufficient. Likewise, the claim must have been based upon the same grounds which form the basis of the suit. A suit upon one ground may not be founded upon a claim for refund stating entirely different grounds.

These steps should be taken during the pendency of the motion before the department with the definite thought in mind that a proper foundation shall be laid for future court action. Otherwise, due to the statute of limitations, it may be too late to lay the proper foundation after the department has made its rejection. In this respect the negotiations before the department are similar to a trial in the lower court. The foundation for the appeal must be laid during the trial. It is too late when the trial court has entered its judgment.

The preliminary conditions having been fulfilled, it is necessary to consider the nature of the suit to be brought and the court in which it should be brought. There are two branches of the judiciary in which the suit may be filed. The action may be brought in a federal district court, of which there are now over eighty sitting in the various federal judicial districts of the United States. On the other hand, suit may be filed in the United States court of claims at Washington. We will consider the classes of actions to be brought in each of these courts.

As stated above, a sovereign state may not be sued without its consent. At common law, however, the judges found a mode for avoiding the stringency of this rule in cases where taxes had been illegally collected. They permitted suits, sounding in assumpsit, to be brought against the collector to whom the taxes were paid, provided the taxpayer had paid the taxes under duress or protest and had thus put the collector on notice that the taxes were considered illegal and that suit for their recovery would be instituted. In the absence of such a protest there was no way at common law for recovering taxes which had been illegally paid. This common-law right to sue the collector was adopted by the federal courts of this country and is recognized today. However, section 1116 of the revenue act of 1926 has relieved taxpayers of the necessity of paying the taxes under protest. The suit against the collector may be brought in any amount and must be filed in the district in which the defendant, the collector, is a resident at the time the suit is filed.

The rigor of the common-law inhibition against suits against the sovereign was relaxed by the enactment, in 1887, of the Tucker act, which made it possible to sue the United States directly for "claims not exceeding $10,000 founded upon the constitution of the United States or any law of congress, or upon any regulation of an executive department." Suits for the recovery of taxes illegally collected have been held to be included within this definition. Further, the revenue act of 1921 amended the Tucker act to allow suits for taxes to be brought against the United States "even though the claim exceeds $10,000, if the collector by whom such tax, penalty, or sum was collected, is dead or not in office at the time the suit or proceeding is commenced." This obviates the necessity of proceeding against collectors long since gone from office, or against the personal representatives of deceased collectors. Where the United States is named as defendant, the Tucker act requires that the petition must be filed in the district in which the plaintiff resides.

In all such cases in the federal courts the rules of practice and procedure are the same as in other civil suits. The "Rules of decisions" act of 1789 has been held to require the district courts to follow the rules of evidence enforced by the state courts of the state in which the district court sits. The conformity act of 1872 requires that the practice, pleadings and form and mode of proceeding in the federal courts shall conform to like practice in the state courts. These statutes apply to suits to recover taxes.

Summarizing, we find that in the district courts the practice in tax suits is largely the same as in any other civil suit. If the amount sued for is less than $10,000 the action for recovery may be brought either against the collector or against the United States. If, however, the taxes total more than that amount, the action must be brought against the collector to whom the taxes were paid, unless he is dead or out of office, and in that event the United States may be named as defendant. Only one class of suit is permitted; the taxpayer may not join both the collector and the United States as defendants.

Suits in the court of claims will be found more acceptable in many respects. The action there may be brought in any sum and regardless of the status of the collector to whom the taxes were paid. In that court the United States is always named as defendant. Another important advantage is that the docket of the court is not so crowded as in many of the district courts. More important, however, is the manner of taking testimony and conducting the hearing.

The taking of oral testimony before the court of claims at a formal hearing is a rare occurrence. Under statutory authority there have been appointed a number of commissioners of the court whose duty it is, under the law and the rules of the court, to take testimony and making findings of fact. Virtually all of the testimony in cases pending before the court is taken under the jurisdiction of these commissioners. The rules provide that where convenient the testimony shall be taken in the county in which the witness resides. The rules likewise provide for the taking of testimony on deposition before a notary public or other officer authorized to certify to such testimony. When the petition is filed with the court and answer made by the government (usually a general traverse, or denial) the case is assigned to one of the commissioners for a report of the facts. Arrangements can then be made with the commissioner to produce the witnesses before him or to take depositions before a duly authorized officer of the locality in which the witnesses reside. In some instances the testimony is taken both by deposition and orally before the commissioner. At the conclusion of the testimony the parties will be permitted to file with the commissioner suggested findings of fact based upon the testimony adduced. The commissioner then makes his report to the court and the parties are allowed thirty days within which to object to his findings. These objections will be passed upon by the court. Briefs are then filed by the parties and in due course the case is set down for oral argument before the court itself. Thus, in the usual case, the only actual appearance before the judges of the court is to make oral argument on the basis of findings of fact as reported by the commissioner and the printed briefs already filed.

It will readily be seen that the procedure before the court of claims is likely to be more convenient and expeditious in tax cases. It is certain that the procedure there is no more difficult and the rules of pleading and evidence no more stringent than those which are enforced by the board of tax appeals, and there should be no more hesitancy, in a proper case, in seeking the relief which this court affords than there now is in petitioning the board of tax appeals for a redetermination of a deficiency.

In all probability, if a case has justified the expense and inconvenience of a long and vexatious litigation before the treasury department, court action is likewise justified. At all events, it is certainly the duty of the representative of the taxpayer, when he believes that an erroneous decision has been rendered by the department, to apprise his client of the further possible relief by an appeal to the courts and to place before him the full facts of the matter so as to enable him independently to reach a decision whether or not to proceed with the case.

Organizing for Inventory *

BY ROBERT IGLAUER

My first reaction to a request for a paper on inventories was concern lest the subject might be too commonplace to arouse general interest. But on further reflection it became evident to me that the theme deserves attention, although my attempt must necessarily be confined to a discussion of a few of the major problems of this vast subject. It is particularly the purpose of this paper to supply fuel for a free interchange of opinions on some of the more interesting phases of inventory tasks with which the corporation accountant and the outside auditor are confronted.

I might have discussed the retail method of inventories in department stores versus the cost method. A great deal of literature is available on this subject and congresses have been held to consider it. Or I might discuss the problems of inventory procedure and valuation principles in other specialized lines of business. But I decided to select a topic that will be of wide interest, so I shall first consider the organization of inventory activities that may be termed to apply to non-specialized lines of industrial enterprise.

Inventory time usually comes once a year, and to the uninitiated this is a time of plant shut-down, counting the stock in the storeroom, repair of machinery and catching up on clerical work that is behind schedule during this period of slowed-down activity. To the initiated this inventory period means something different. To them it means that a temporary organization must be whipped into shape, instructions issued, plans, preparations and rules formulated and a supervisory control exercised in the taking of the inventory. All these labors carry with them much criticism and no reward. Because of this fact, inventory tasks are greatly neglected in many instances. The work is often looked upon by the management as just so much lost motion and just so much extra expense. It is hard to arouse enthusiasm and the outcome often is that the result falls far short of what the inventory is always intended to accomplish and what it could be made to accomplish if the right kind of effort and intelligence were put behind it.

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*Address delivered before the Maryland Association of Certified Public Accountants, January 9, 1929.

To begin with, the inventory work is too often not planned at all. When it is planned it is often planned far too late. The supervision is left to subordinates, the temporary organization which must do the work is given perhaps a day's notice, perhaps only a few hours' notice, to the effect that they have been drafted for inventory duties, and all enthusiasm is lacking. In fact, there is often great reluctance and resentment and certainly no feeling of responsibility. People drafted from other departments object to working under a temporary boss and the inventory supervisor often lacks the broad experience and viewpoint that he should possess, for it must be remembered that the inventory is usually one of the largest items among the assets of a balance-sheet. The inventory supervisor ought to be one with a complete knowledge of the company's system and organization as well as of its products. At the same time, he ought to be one who understands the important part the inventory will play not alone in the accounting department but also as a source of valuable information to the purchasing, production and sales departments.

The first essential in planning an inventory procedure is the appointment of an inventory supervisor of the right caliber, and this choice had best be made by the general manager. The inventory supervisor should then appoint an inventory advisory committee of which he might or might not be a member, and, depending upon the size and complications of the business, the inventory committee should meet from two weeks to eight weeks in advance of inventory time in order to make plans and preparations. These plans and preparations should be reduced to the form of an inventory manual containing personnel charts, in which the specific assignment of each person drafted for inventory work is clearly indicated. It must also contain explicit rules for performing the various inventory duties. I have prepared a chart (marked exhibit "A", page 194) of an inventory organization in a medium-sized plant, in which the personnel assignments are reflected and the routine to be followed is indicated.

It will be seen that some men are assigned to the physical counting and that there are some tag writers. The tag writers should be of a caliber somewhat higher than the men who count the goods. The tag writers should probably be the foremen of the various departments in the factory, or the storekeepers in a merchandising establishment. Where large quantities have to be counted or where the material has to be shifted for facilitating

12-31-28

INVENTORY ORGANIZATION

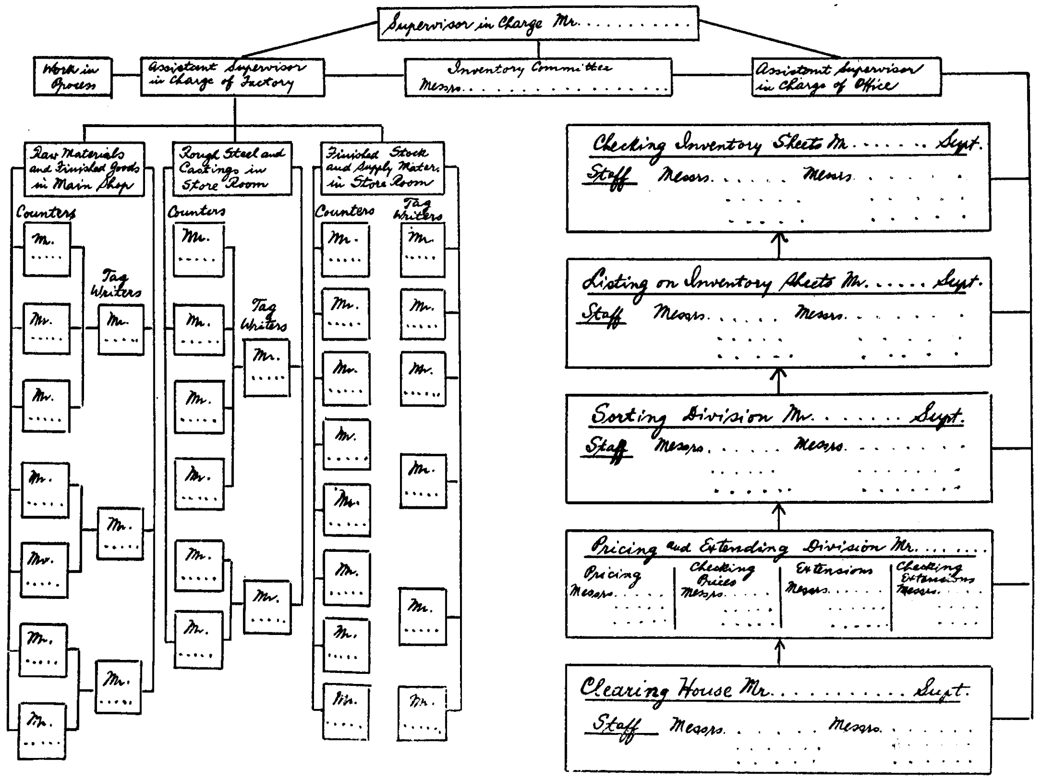

EXHIBIT "A"

count, the tag writer might take care of the work of a number of counters or weighers.

The clearing house is an organization appointed by the inventory committee to receive the tags from the tag writers and to pass them on to the pricing staff. Then there are the people who extend the values, and the tabulating or sorting table where the inventory tags are sorted, and, finally, the division listing the tags on inventory sheets.

12-31-28

INVENTORY TAG NO.....

PART NAME . . . . SIZE . . . .
. . . .
LENGTH . . . . .

PAINTED ☐ GALVANIZED ☐ BLACK ☐

QUANTITY. . . . UNIT PRICE . . . .TOTAL . . . . .

PRICED BY. . . . . . . PRICE CHECKED BY. . . . . .

EXTENDED BY. . . . . EXTENSIONS CHECKED BY. . . . .

CLEARING HOUSE O.K.	ORIGINAL COUNT BY . . . . RECOUNT BY . . . .

EXHIBIT "B"

And now, permit me to dwell somewhat on the manner in which the control is exercised and on the routine of procedure. Some twenty or thirty years ago, most inventories were listed on sheets while the goods were being counted and if, through a disarrangement of the stock or because of the peculiarities of a business, the stock of an individual article was scattered, the same items might appear a number of times on the inventory sheets. The rotation of the items appearing on the inventory sheets was anything but logical and to help solve the difficulties elaborate indices had to be prepared, which sometimes served the purpose of finding items sought, but more often did not. We have here, of course, the same arguments in favor of individual tags on each individual lot of merchandise as we have for loose-leaf ledgers.

The chart marked exhibit "B" shows a sample of a very simple inventory tag, and it naturally depends upon the nature of the business whether the inventory tag might be simplified still further or whether it should contain much more information.

The tags are printed in duplicate and numbered serially, the first copy being white and of paper and the second copy being colored and of cardboard. The inventory tags are bound in pads of 25 or 50 with carbon paper attached to each. Then all the pads are listed by their serial numbers on an analysis sheet with the numbers arranged in the vertical column as shown in exhibit 'C" and the names of the employees to whom the pads are issued arranged horizontally.

12-31-28 PAD CHARGE SHEET

Tag No.	J. Black	M. White	F. Green	P. Ellis	H. Norris	
1-24......						
25-49......						
50-74......						
75-99......						

Exhibit "C"

When the number of employees is too large, the names may be placed opposite the pad numbers. Thereafter strips are prepared as shown in exhibit "D," preferably by using a numbering machine, with the numbers running consecutively up to the last number found on the pads, or they may be bought in any commercial stationery store.

As stated before, when the pads are issued the men to whom they are issued are charged, and when the tags come back to the clearing house the first function of the clearing house is to cross the number of the individual tags off on the numerical strips. In this way the clearing house must at the end of the inventory period have unused tags for all open numbers on the numerical strips and if any are missing they can be traced from the pad charge sheet to the men to whom the respective pad was issued. The principal function of the clearing house, besides this control on the use of tags, is to ensure that each tag shows that the material has been counted and rechecked, that it is properly classified and that the designation is complete so as to enable the pricing

12-31-28		TAG NUMBERS
1......		
2......		
3......		
4......		
5......		
6......		
7......		
8......		
9......		
10......		
11......		
12......		
13......		
14......		
15......		

EXHIBIT "D"

division to find the inventory price among their cost records without having to refer the tag back to the shop for correction. The rejection for correction is in this way done at the source and much delay is avoided. The clearing house will initial each tag and pass it on to the pricing division continually without waiting for accumulation. The pricing division will insert the price from the cost records and recheck the tag. The tags are then passed on to the extension clerks and they must be rechecked as to extensions. Thereafter the tags are sent to the sorting tables which are prepared in advance of the receipt of these inventory tags. The sorting tables might be marked off with chalk or in some other suitable way in accordance with the classifications in which the inventory sheets are intended to be prepared. The tags can not leave the sorting table until after all the inventory tags have been sorted, but since physical counts in the shop and the work of the pricing and extension divisions are carried on concurrently, the work can be handled with the utmost dispatch. After all the tags are classified on the sorting tables they are listed on the inventory sheets by groups as outlined. The listing has to be rechecked and then the extensions are footed and the footings are rechecked. Where the inventory contains a large number of different articles, the "Hollerith" or "Powers" system of punched cards may be employed for sorting and tabulating. Under this method the inventory tags would be designed to fit these devices and experienced operators would punch on the tags the information which had previously been recorded thereon in writing. The sorting machine would then be substituted for the sorting tables, where tags are sorted into the intended groups. From there they would go to the tabulating machines where they are added and the machine would automatically run a report. These reports by groups might then be used for listing the complete inventory on summary sheet by these groups, and the punched tags would have to be carefully kept in indexed drawers for ready reference to support the inventory summary sheet.

Just a few words about the physical preparations that have to be made in the shop before the physical count is actually begun. It is extremely important that work in progress be completed as far as it is possible to do so, to the end that this portion of the inventory, which causes the greatest difficulties as far as both listing and valuing are concerned, be reduced as much as possible. Frequently a large amount of scrap material is accumulated during operations and it is advisable to try to dispose of any such scrap material before the inventory period.

The current and salable stock should be physically separated from obsolete, damaged or otherwise unsalable materials. Any raw-material stock which has been requisitioned out of the storeroom for current work but has not been completely used up should be returned to the raw-material stores, unless it consists of heavy materials that can not be moved without considerable expense.

Finally, merchandise that may be on hand on consignment, that is, belonging to others, should be separated from the merchandise owned and should be specially marked. Such materials must, of course, be excluded from the count. As far as out-of-town inventories are concerned, the company may have goods at branch plants, at branch warehouses, at public warehouses, or on consignment in agents', distributors' or customers' hands. Under a proper accounting control, a listing of all stores out of town can be readily assembled from the book records, and the question then to be determined is which of the stocks must or can be physically verified by the company's own personnel or traveling auditors and which should be confirmed by correspondence with distributors, agents, etc.

It might seem trite for me to speak about the accounting procedure with regard to the cut-off of purchases and sales, but I find that while there is as a rule a thorough understanding of the principle involved, there is usually much time lost in determining the procedure in each case because of a lack of an orderly plan. For this reason, it may be well to rehearse briefly the instructions to the personnel concerned during inventory time with these two subjects.

Dealing first with purchased materials, we may establish the following rules:

(1) Goods received before starting the inventory count, for which purchase invoices from vendors are received dated as of the new business year:

Under a proper business routine the presence in the inventory of goods under this heading is evidenced by receiving tickets on file in the accounting or cost department, dated as of the old year. All such receiving tickets should be priced and extended and the liability should be set up as an account payable, before the close of the business year, as a total figure This entry can be reversed on the first day of the new business year and the individual invoices, as received, can be entered in the accounts-payable register or purchase record.

(2) Goods received during the inventory count for which purchase invoices from vendors are received dated as of the old business year:

If facilities at the receiving door permit, the latter should be locked against incoming goods during inventory count and the receiving ticket should be dated as of the new business year. Purchase invoices received, however, should be entered on the purchase records and charged to goods-in-transit account.

If facilities for storing outside of the receiving door are inadequate, the receiving clerk should be supplied with inventory tags and it would be his duty to prepare tags for all goods received. Great care must be exercised to see that the colored copies of the inventory tags remain attached to the goods when the latter are moved to the storeroom.

(3) Goods received during the inventory count for which purchase invoices from vendors are received dated as of the new business year:

If the conditions of the receiving department permit, such goods should be excluded. No problem would be encountered in the office since the vendor's invoice will naturally be entered during the new business year.

Where it is necessary to admit such goods, however, the receiving clerk should prepare receiving tickets dated as of the new business year and copies of these receiving tickets must be attached to the goods with a prominently visible notation on them, "Not to be inventoried."

(4) Goods received in the new business year for which purchase invoices from vendors have been received during the old business year:

All invoices from vendors dated as of the old business year, but the goods for which have not arrived when the inventory count is completed, should nevertheless be shown as a liability as of the close of the old business year, the offsetting entry to be recorded against goods in transit.

As to the cut-off of sales, the following rules apply:

(5) Outbound shipments (sales):

In order that there may be no confusion between inventory and accounts receivable, all materials shipped prior to the start of the inventory must be evidenced by invoices with that prior date, and the same rule applies to goods packed and ready for shipment on the shipping platform, even though they may not actually have been shipped.

A little more difficulty is experienced with materials removed from stores during inventory time. In these cases, the shipping order must have the approval of the inventory supervisor, who will see to it that the goods reach the shipping department with the inventory tags attached to them. The sales invoice covering such shipment must be dated as of the first day of the new business year, as otherwise there would be a duplication of assets and an overstatement of the surplus account on the balance-sheet.

Any of the rules and procedures must, of course, be adapted to the particular business in each case, and the larger and more ramified the business, the more detailed and explicit must be the rules and instructions to be incorporated in the inventory manual.

The pricing of the inventory offers scope for some very interesting observations. There is a cardinal rule in accounting about the valuation of inventories, at least as applicable to most businesses and industries. This cardinal rule is: cost or market, whichever is lower. That is a very fine and clear-cut principle and I have no fault to find with it as a principle, but I do find it hard at times to apply the principle to an actual given case, for the simple reason that the research labors in terminology conducted by the Institute have not crystallized to a point where we can say with positive assurance what cost is and what market is.

Dealing with raw materials first, we may ask ourselves whether the cost to be used is the average cost of the year's purchases, the cost of the last purchase or a figure arrived at by applying the averaging principle to individual perpetual-inventory records. Income tax stands on the principle of first in, first out, and contends, therefore, that we must assume that the goods purchased the earliest were disposed of the earliest, when the identity of individual purchases is lost through intermingling.

Cost accounting, however, permits and in fact favors the average theory, which means the establishment of a new unit price each time the cost of a new purchase differs from the previous average valuation. Another problem is encountered when a standard-cost system is used and particularly when it extends its standards to the valuation of raw materials. Under the standard-cost plan the perpetual-inventory value of any given raw material, once it has been set, is used for the cost records, and any variation from this fixed value of new purchases is treated as a variation and is closed out to cost of sales or to profit and loss. Obviously, when a closing inventory is priced at standard costs, therefore, these standard costs are likely to differ from the actual cost determined upon any of the above bases and they are also likely to differ from the market prices at the close of the business year. If we apply to work in process this standard method of valuing raw materials at predetermined rates and if we apply predetermined standard labor rates to the cost of production as well as predetermined overhead rates, we arrive at standard predetermined rates for finished materials.

It is, of course, possible under standard-cost procedures to determine actual costs on any particular production order or product, and this is in fact one of the important purposes of the standard-cost system. When a number of production orders have been completed during the year, it would be a laborious task, however, to retrace the steps and arrive at a valuation for inventory purposes based on actual costs. Moreover, the valuation at actual costs would cause complications, inasmuch as these costs could not be used to continue the cost system in the new business year. Even under the actual-cost method, unit costs are usually established by assuming predetermined rates for factory overhead, and the difference between the factory overhead incurred and the amount absorbed is closed out to cost of sales or to profit and loss. It remains then a question, when inventories at the end of the year are valued at the unit costs established by the cost records of an actual-cost system, how the over-absorbed or under-absorbed factory overhead may affect the unit costs used for the valuation of the inventory at the end of the year. In my opinion, while I, of course, unhesitatingly accept the principle of cost or market, whichever is lower, we must be open-minded regarding the definition of the word "cost" and we must accept the rates established for inventory purposes by the system in use by the company concerned, provided that we find the system of cost accounting scientific and fair in its main features. We must be ever watchful, of course, to take into consideration the relative importance of any probable variation to the total volume of business done, to the value of the total inventory as ascertained and last, but not least, to the financial condition of the company.

Early History of Bookkeeping by Double Entry

By P. Kats

In the year 1878 the citizens of San Sepolcro, a small place in the province of Arezzo in mid-Italy, adorned with a mural tablet the house where, about the year 1445, one of its most famous citizens, Luca Paciolo, or otherwise Fra Luca di Borgo San Sepolcro, had been born. On this memorial stone they extol the merits of that great man and give expression to their feelings of shame for having let him rest in oblivion for 370 years. On it Paciolo's significance is commemorated, both as a mathematician and as the first who published a treatise on commercial bookkeeping by double entry.*

This is not the place to inquire what reasons the good citizens of San Sepolcro had in stating the period as being only 370 years during which that illustrious son of Italy had been forgotten; for our present purpose it is sufficient to note that for many years he had remained in oblivion. His treatise on bookkeeping was not appreciated until long after his death and apparently remained unknown outside Italy; it was not until the year 1869 that interest in it was awakened, when Professor E. Lucchini, in a paper read to the Accademia dei Ragionieri at Milan, for the first time—after 375 years of oblivion—drew the attention of the accountants there assembled to a work by which henceforth in the world's memory will live forever the author of the now famous *Particularis de Computis et Scripturis* ("About accounts and other writings"), which is the 11th treatise of the 9th part of the monumental *Summa de Arithmetica, Geometria, Proportioni et Proportionalità*, printed in Venice in the year 1494.

Since then the keenest interest has been aroused in the frater's forgotten work and soon after translations were made in German, modern Italian, Dutch, English (2), Russian, Czech and Japanese. His life was studied, his biography written and his work extolled as the fons et origo of all literature on bookkeeping by double entry in Italy and abroad. Flying from one extreme to

*A Luca Pacioli—che ebberro amico e consultore—Leonardo da Vinci] e Leon Battista Alberti—che primo die all'algebra—linguaggio e struttura di scienza—avviò il gran trovato—d'applicarla alla geometria—insegnò la scrittura doppia commerciale—dettò opere di matematica—base e norma invariate—alle postere lucubrazione—Il popolo di S. Sepolcro—vergognando 370 anni di oblio—al gran concittadino—poneva—1878.

the other, from complete neglect to indiscriminate hero-worship, many of the ablest and most fair-minded students of accounting history decried all early works after the *Particularis* as so many clandestine and slavish imitations of the superior treatise of a man whose name and writings their authors had not even had the decency to mention.

But gradually more critical views have been taken and it has been pointed out that, in all probability, the *Particularis* themselves were not an original treatise but the reproduction of a never published manuscript, used in the commercial "scuole" of Venice, and that the treatises by Manzoni, di Bianchi Ympyn and Hugh Oldcastle were also based on that lost manuscript. This opinion gains in probability by the fact that the older *Particularis*, etc., contains several names of commodities, sentences and even whole chapters which, for no apparent reason, do not appear in any of the works of the alleged three imitators in chief, in whose writings, on the other hand, several matters are discussed foreign to the older dissertation.

At this point it is meet to ask a pertinent question: How is it that treatises on bookkeeping written outside Italy, unless their authors distinctly state that they are following Venetian examples, never conform to that type? Look at the manuscripts and printed works of Mathäus Schwarz, Heinrich Schreiber (Grammateus), Johann Gotlieb, Erhart von Ellenbogen, Valentine Mennher de Kempten and others outside Italy; look also at the fragments of non-Venetian books of account preserved from days prior to the publication of the *Particularis*, and at the examples of a non-Venetian ledger in the second addendum to that treatise; ponder over the chapters on bookkeeping written by Benedetto Cotrugli and Girolamo Cardano and say whether or not there is abundant substantiation for Fra Luca's own statement that elsewhere in Italy there were methods of bookkeeping in use other than those in Venice. That answered, it will not be difficult to deduce that, whatever the authors mentioned may have owed to Italian *practice*, they were under little or no indebtedness to Fra Luca's *Particularis de Computis et Scripturis* or to any other known Italian works.

There is every reason to believe that bookkeeping has gone through several experimental stages and that, until there was an actual survival of the fittest, there has been at least one form that ran close behind the victor in the race for supremacy, and influenced it to such an extent as to account for the subsequent abandonment of many of the peculiarities that were considered essential by Venetian authors.

In examining one of the more important different types of bookkeeping, it would seem advisable, in support of this thesis, to begin with later forms that look like survivals of older ones rather than to start from the earliest traces.

JOHN COLLINS (1625–1683)

Though John Collins was an English author, it is as well to begin with him because he combines most of the points to which it is desirable to draw attention. Moreover, he was not a writer of the ordinary type, but a mathematician of note and Fellow of the Royal Society, who had studied and practised merchant's bookkeeping for the best part of seven years on board a ship hired by the Venetians in their struggle against Turkey. Hence his bookkeeping and terminology were influenced by the Italians more directly than those of any other English author.

His treatise, known as *An Introduction to Merchants-Accomptes*, was first published in the year 1652, reprinted in 1665 (this edition was lost in the great fire of London) and again, but amplified, in 1674. It consists of seven applications of bookkeeping—or questions, as he prefers to call them—of which the third, "A question of factorage, or goods received by consignation, and returns shipped off, with an analysis thereto belonging," is the one best suited for our purpose.

The question is stated by Collins himself as follows:

> "Thomas Sweet, a Merchant, removing to settle at Seville, or St. Lucars in Spain, owes at his going over several debts, and has several more owing to him. He constitutes Thomas Wood his Factor here to receive and pay the said debts, as likewise to divend (?) or sell off such goods as are in his hands, or consigned home to him, who makes returns in Lead and Fustians, the whole employment cleared with an account current for the Owner."

This statement is followed by an inventory and waste-book.

The inventory, dated September the first, 1649—which was obviously started three years before the book was first printed—consists of:

(1) A list of debts owing by Thomas Sweet, the master.

(2) A list of debts owing to the principal. 1 and 2 with the respective amounts due.

(3) Goods belonging to the owner, i. e. 1/32nd part of the ship "Speedwell," a house with a warehouse thereto belonging,

whereof there is a lease of two years yet to come—paying annual rent; 32 bags of Barbados cotton; 12 bags of West Indian ginger, 100 pieces of counterfeit Venetian fustians of English manufacture and Thomas Sweet's share of £250 in a Turkish company, whose stock the factor has order to sell for his master. Except for the debts, no values are either extended or put upon the assets, and no accounts are opened for them in the ledger except for cotton, ginger and fustians, i. e. for the charges, including factorage, paid on them when the goods were received and sold.

To the same accounts the sales are credited and when the merchandise is all disposed of the net proceeds are transferred to the master's account, there being no capital account, but if there remain any goods unsold when the accounts are closed, they are passed out of their respective accounts with their quantities only, no values being attached to them. Obviously, these accounts are subsidiaries of the principal's account, to which the charges might have been debited and the proceeds credited direct, as was done on selling the master's share in the Turkish company. Accordingly, the accounts for these commodities are styled, for example: "Ginger for Account of Thom. Sweet." They all contain quantity columns from which the remainders that should be in the warehouse can easily be ascertained.

Discounts and other allowances granted or received are debited or credited direct to the master, whose account at the start shows:

Debts payable, £904.12.00.
Debts receivable, £557.05.06.

Owing to the omission of all other assets there is, therefore, an apparent deficit of £347.6.6. A similar instance of liabilities exceeding assets is found in Angelo Pietra's *Indrizzo dei Economi* (1586), which is likewise a specimen of steward's accounting.

Owing to the direct transfer of the balances of the various goods accounts to the one raised for the master, there is none raised for profit and loss. There is, however, a "balance" account that contains only outstanding debts payable and receivable, and cash in the factor's hands for his master's account.

Since this is factor's accounting, it is obvious that, not being responsible for the *values* of the ship's part, the house, share in the Turkish company, cotton, ginger, fustians and other commodities received for sale, the factor does not credit his master until money becomes actually due. Nevertheless, in some instances, if the principal—desiring credit forthwith—instructs the factor to appraise the goods in the latter's books according to an account sent, this is done but, as our author states, "more for information than for any other use."

In the foregoing a type of accounts is sketched such as even nowadays might be kept by any commission agent and, provided there is no law compelling one to include the whole of one's capital in his books of account, there seems no reason why a merchant, especially one in a small way of business, should not keep his own books in exactly the same way, i. e., he may be satisfied by keeping a note in his inventory of such assets as houses, land, ship's parts and others that are not likely to change hands. Furthermore, if the business is very small—for example retail trade—and the commodities are constantly under the master's eyes, he may consider it sufficient to raise one general "goods" account only, from which may be ascertained his receipts by the sale of all commodities, their cost and the particular expenses paid for them, as also all charges of a more general nature for which he does not care to open a special account as, for example, he may do for his household expenditure.

Factor's bookkeeping therefore differs in contents from the Venetian bookkeeping expounded by Paciolo and other Venetian old masters in that (1) there is no capital account: the master's personal account, which replaces it, records only items of which the value is certain, such as cash and debts payable and receivable; (2) there is no profit-and-loss account; (3) the various goods accounts, although opened immediately at the start, contain provisionally nothing but quantities, and the money received and paid in respect of them really should be posted on the master's account: to the master, accordingly, the balance of money values, in the shape of net proceeds, either before or after deducting cost, is ultimately transferred; (4) in the same way all other accounts might be balanced by transfer of their remainders direct to the master's account, unless it is preferred, as it was by Collins, to assemble them first in a "balance" account, and in this case only the difference between its debit and credit sides should be transferred; (5) remaining quantities of goods are carried, but without any money value, direct to the new books.

The books used by Collins consisted of an inventory, waste-book, journal and ledger.

In the inventory, contrary to Paciolian practice, assets are extended and totaled if their values are certain, as in the case of debts and money in the cashbox; otherwise they are merely accurately described. No instructions are given to keep the inventory secret in a separate book and, after the transfer of its items to the journal, no oblique lines are drawn to cancel them and to indicate their transfer.

The waste-book is not merely a book which, during the absence of the master or bookkeeper anyone able to write may handle. Collins desires it to be kept neatly and with great care. Extensions of money are made, sometimes by using double money columns; no lines are drawn through journalized waste-book entries.

The journal differs a great deal from Paciolian forms. There is no "per" and // (or ;) and "A" to indicate the accounts that should be debited or credited and frequently there is more than one debtor against one creditor, or vice versa. Amounts coming into question are stated in the narration in Roman numerals and in the extension column—no longer a mere margin—in Arabic figures. The indication of debtor and creditor is made by preceding each in a narrow column on the left by Dr. or Cr., as the case may be.

The 5th Ditto (October 1649)

4	Dr.	Lead for the sum of Lxxxj£. j^s. jx^d and is for 50 bags of two notches, weighing gross 7 Fother jC. at xj£	£ 81	s. 01	d. 09			
4	Dr.	Fustians English manufacture etc.	100	00	00			
2	Dr.	Cash, for vj^s vj^d etc.	00	06	06			
4	Cr.	John Blay for the particulars by him made good	181	08	03	181	08	03

Note that no pair of slanting lines is drawn through the entries to signify their posting in the ledger.

The ledger does not differ materially from Paciolian and Manzonian examples. On the debit side all entries are preceded by "To" and on the credit side by "By." As a rule, every entry occupies only one line. No slanting lines are drawn across the sides of the accounts when they are finished or transferred to another place or ledger. The various goods accounts contain, somewhere near the center of the narration, a column to take the quantities coming into question.

So much for Collins's factorage accounts. It will have been noticed that they differ considerably, both in contents and form, from Venetian examples as known through Fra Luca and other writers of his time. It now remains to be seen to what extent Collins followed established Italian practice, wherefore a step back may be taken.

Matteo Mainardi, Bologna, 1637

Matteo Mainardi is responsible for a treatise called *Il Cambio Reale per Ogni Piazza*, of which there appear to have been reprints in 1686 and 1700.

As in the case of Collins, there is a "personal" instead of the alternative capital account for the owner of the business, who is a shopkeeper named Arcangiolo Sacchi. It takes the balance of the profit-and-loss account (not used by Collins) as well as the balances of all others, i. e. without any intermediary account. In this the author differs, not only from Collins, but also from Fra Luca, who taught the transfer of all such balances through no intermediary account at all, but direct to the new books.

It was a favorite notion of Mainardi's to exemplify the bookkeeping of a person who acted in the interest of others, for example as a surviving partner who renders account of his stewardship, or as a "commissario testamentario." Essentially, his bookkeeping is not very different from that of Collins's factor.

The journal entries resemble curiously those of the Italianized English author, with the difference that the debtor account is preceded not by Dr. but by "A" or "Alle" and the creditor account by "A credito." In a number of entries there is often only one debtor against more than one creditor, or vice versa, as in the English work. Furthermore, the amounts coming into question are also stated twice, i. e. in words and in Arabic figures. No pair of parallel lines is run across the entries to indicate their posting to the ledger.

Laus Deo, & B. Virg. Rosarij M.DC.XXXIII
Adi 31. Decembre Sabbato

14	A Michele Landinelli nostro bracente à Romanello lir. vintinoue, cioè lir. vinti per la pigione della casa, e lir. noue quat. per corbe due, quar. due d'orzo, hauuto più giorni sono dal Fattore, d'accordo . . . . £	29	—
7	A credito Luogo di Romanello . . . . £20.—		
9	A credito Orzo in granaro cor. 2. quar. 2 . . . . £9.—		

Although the books are supposed to be those of a "commissario testamentario" the ledger contains, nevertheless, accounts raised for various "Possessione" as also for different kinds of expenses (spese d'elimosine; spese di reparationi, and so forth).

(To be continued)

The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

EDITORIAL

Bankruptcies and Corruption

There has been much speaking and writing of late on the subject of the abuses which have crept into the administration of the bankruptcy laws in some of the states, notably New York. It is openly said, and generally believed, that all is not as it should be in the appointments of receivers. It has been alleged that appointments as receivers or trustees in bankruptcy have been the peculiar perquisite of small groups of friends of some courts and that men designated to administer the affairs of bankrupts have sometimes lacked the rudimentary notions of business or, even worse, have conducted the management or wound up the affairs of bankrupts with an eye single to the advantage of the receiver or trustee. The evil is said to have grown to such magnitude that it has become a serious menace to the course of credit. When incompetent or unworthy receivers have the direction of affairs in their hands, honest claims, which might be paid in full under proper administration, often become valueless. The upright receiver's first thought is the possibility of carrying on the bankrupt business until it can emerge from its difficulties, make a fresh start on the way to success and pay, not only its legal liabilities, but its moral obligations as well. When such a man takes charge it is generally found that troubles are surmountable, the bankrupt usually is rehabilitated and everyone concerned comes out of the unpleasantness with a clear conscience and a better faith in human nature. But, unfortunately, there have been many appointments to fiduciary offices which were dictated not at all by solicitude for the welfare of the bankrupt and his creditors, and in New York especially the evil of corruption has spread so far that the papers have been speaking of a "bankruptcy ring." Some people have seemed to believe that it is impossible under the present system of government to escape the incubus of this vile species of graft; but as it often happens in the history of business when things become too bad someone has done something effective about it. The bar associations at last have been perturbed by the slur which has been cast upon the integrity of the bench. Committees have considered ways and means, and many sorts of devices for the protection of the public have been conceived.

Banks, of Course, Are Good

To the accountant the whole problem seems so easily soluble that it is amazing to find that courts generally have failed to discover the solution. But distinct improvement has been noted recently in the papers. Six federal judges for the southern district of New York are understood to have agreed to appoint a certain bank, the Irving Trust Company, to handle federal bankruptcy cases arising in that district. The precedent thus set will probably be imitated in other parts of the country and thus a great step toward complete reform will have been taken. It is indeed much better that a trust company should be assigned to act as receiver or trustee in bankruptcy and it is not indulging in excessive optimism to believe that the day of the "bankruptcy ring" in its worst form will soon pass. Some bankers, of course, are jubilant at the recognition of their institutions as agents suitable for the administration of bankruptcies, but it must be remembered that the selection of any one bank as the general clearing house for receiverships may lead to jealousy.

But Accountants Would Be Better

Accountants naturally will feel some chagrin at the action of federal judges in New York because experience in other countries has demonstrated conclusively that accountants are the most suitable persons to serve as receivers. More than five years ago this magazine drew attention to the record of bankruptcies abroad and pointed out that lawyers, who in this country have almost always been regarded as the only possible recipients of receivership appointments, are usually not appointed in Great Britain. According to the reports of the British board of trade public accountants constitute the great majority of the persons appointed to administer bankruptcies and it is noteworthy that the costs of receiverships and trusteeships are very low. For example, in the year 1921, the costs of trusteeship were 19.51% of the gross amount realized. It is perhaps permissible to quote from an editorial appearing in THE JOURNAL OF

ACCOUNTANCY in 1923. The subject is of sufficient importance to merit repetition.

> "Lawyers are not usually appointed in Great Britain as trustees and receivers. The creditors prefer that a public accountant should act in this capacity and a small committee of two or three creditors generally coöperates with the accountant in the winding up of the business. The creditors control the proceedings in about 85 per cent. of the cases. In the other 15 per cent. the appointment of an official receiver (who is an officer of the high court of justice) is usually to punish the debtor. Such official receiver may ignore the wishes of the creditors, who have no control over him, as he takes his orders from the high court. As a matter of fact, that usually means that he administers the affairs without interference of any kind. The only way in which lawyers are employed in British bankruptcies is in the presentation of petitions in bankruptcy, drawing deeds of arrangement with creditors and acting as legal counsellors in a very restricted degree for the trustee. Special applications to the court by official receivers or to the creditors by accountants acting as trustees must be made before lawyers may be employed by trustees in bankruptcy. The official reports of the inspector general in bankruptcies show only two kinds of trustees, namely, official receivers and non-official trustees. British creditors appear to have a pronounced preference for accountants as trustees in the belief that accountants will work in coöperation with the creditors and thus bring about the best adjustment possible in the circumstances. These facts should be impressed upon the American business man and also upon courts. It is not certain that trusteeships or receiverships are likely to prove the most lucrative part of an accountant's practice, but in the interest of the public the man best fitted to administer affairs should be appointed, and the old theory of appointing friends of the court or political lame ducks which has sometimes prevailed should be entirely abandoned. When all is said and done the purpose of proceedings in bankruptcy and administration of bankrupt estates should be the protection of the creditor rather than the personal glory and emolument of the one appointed administrator."

It may be that the administration of bankrupt concerns by banks will be satisfactory, but it is doubtful if any ordinary banker will be found to have the experience and technical knowledge of accounts which are essential to the most effective and economical administration of affairs. As is hinted in the editorial from which we have quoted, receiverships should not be regarded as highly remunerative, but they do constitute a field in which the accountant is preëminently able to render service and it seems probable that the time will come when courts and the business public will demand that the affairs of insolvents be conducted so as to produce the best results in the most economical manner and in the shortest possible time.

An Advisor in Bankruptcy

As an evidence that the best way of handling receiverships is beginning to be recognized, it is interesting to record that Judge William Clark, of the United States district court in Newark, New Jersey, recently called upon the Society of Certified

Public Accountants of the state of New Jersey to suggest the name of thoroughly qualified accountants to assist him in examining applicants for discharge from bankruptcy. The request was immediately granted and the accountants selected have already been able to render material assistance in the examination of applicants. From such a beginning it may not be too much to expect the introduction of the principle, so long approved and so satisfactorily followed in Great Britain, that accountants should be appointed, not to advise, but to act as administrators of insolvent concerns. The qualified approval which accountants give to the selection of a bank to administer bankruptcies is not ungracious. The change which has been introduced is good as far as it goes. The hope now is that the reform will be carried to its completion and that the courts will appoint accountants to do the work which no one else can be expected to do quite so well.

How to Terminate An Engagement

A man whose practical experience in accountancy has been wide and long recently told a story which has significance for all who are concerned in or with the practice of the profession. He said that a rather large and active corporation had been on his list of clients for several years and once or twice during that time he had been compelled to remonstrate against little inaccuracies or insufficiencies in the keeping of the company's records or in a proposed statement of financial position. His protests had aroused a good deal of enmity but his demands for reform or frankness had always been met, until last year, when the company refused to accept dictation and called upon him to sign the balance-sheet in a form which was misleading if not actually untrue. He declined to certify and reiterated his objections to the company's manner of stating its condition. The president of the corporation became emphatic. The accountant, he said, would sign the statement as it was or someone else would do so. The accountant blandly replied that someone else would have to sign such a statement if it was to be signed at all. At this point diplomatic relations were severed, and the accountant is now interested in a speculative way only.

Concerning Remote Contingencies

The story, however, goes much further. It appears that the client then approached another fairly prominent accountant and asked him point blank if he would sign the company's balance-sheet. The story then reports that this newly introduced accountant agreed to do whatever the client required and not to ask any foolish questions nor to stand long upon any obscure point which probably would be of no importance anyway. That is what the story tells one, but that surely is incredible. It is much more reasonable to suppose that the president of the corporation, calling upon the second accountant, said something like this: "Mr. Doe, we have been having our accounts audited for several years by Mr. Smith, but now we are thinking of making a change and we should like to have you give consideration to the possibility of making an arrangement with us. Before we go on to the details, however, I wish to explain certain peculiarities in our business which you must understand prior to any audit or report which you may make. Mr. Smith is a stubborn sort of fellow and he refused to sign our balance-sheet because he felt that a contingent liability, the existence of which we admit, should be set out in the balance-sheet. Now, while we all know that theoretically there is such a contingency, we also know that it is so remote as to be invisible to the naked eye. There is not one chance in ten thousand that a real liability will ever develop. On the other hand, the extent of the contingent item is so great that it would seriously affect our credit if bankers' attention were directed to it. So we have decided that the item shall not appear on the balance-sheet. Now, with our assurance that the contingency is purely theoretical, I should like to ask if you will consent to certify the accuracy of our accounts." The accountant may have replied: "I should never place my name on any balance-sheet which was in any sense inaccurate"—this to impress the client and to still the voice of his own conscience—"but one can often be too technical and what you have told me indicates that Mr. Smith is rather narrow-minded. He is a very good accountant"—this to conform to the letter of the law of fellowship—"but I try to look at things in a more comprehensive way. I certainly should not hesitate to accept your statement that the contingent item which you describe is quite harmless. Indeed, I do not think it should be shown except perhaps in some confidential way to the directors." That would have settled the matter—and in fact it was settled. The story says that Mr. Doe agreed blindly to sign a statement prepared by his client. Mr. Doe would say that he did nothing of the kind—he merely agreed to apply the broad principles of accounting to the case and to avoid tiresome meticulousness.

There Should Be One Answer

Has any reader of these notes ever heard of anything of this sort? Has one ever battered down the opposition of an unquiet mind in the small hours of the morning with such an excuse for acquiescence? Of course, this is a story which has come to us without supporting evidence. It is true, however, that the accounts of the client are now audited by Mr. Doe and that there is nothing in the published balance-sheet to suggest the existence of the kind of liability which, according to Mr. Smith, does exist. It is impossible to know all about this case. One man's word, in law, is said to be as good as another's. If the story is true, the second accountant is guilty of a low and sordid act and his crime is treason. If the truth lies somewhat short of the place indicated by the one who tells the story, it is yet bad enough. One can not conceive how any man who professes to have the least sense of decency could accept an engagement on the terms mentioned and in the face of the refusal of the other accountant. The most that any respectable citizen could do would be to consult first with Mr. Smith and then to return answer to the client. There could be only one reply, unless Mr. Smith were an utterly preposterous person who did not know what he was about. Not once in a thousand such cases could an accountant afford to accept an engagement which had been rejected by another accountant because it called for doing something which did not seem to him to be altogether proper. It would be pleasant to disbelieve the whole story and to fold one's hands in the perfect peace which is said to be found in the assumption that good men are everywhere and that no evil is. But here comes a blunt, outspoken fellow who tells the tale in a veracious way and his words carry conviction. It does look as though the story were true and as though there is in the accounting profession one man at least who is not needed there. Accountancy would be the richer for his departure into other fields of endeavor. It may be superfluous to make suggestions, but such a man might take up banditry or porch-climbing when the weather is better.

But What of the Client?

Leaving out of one's consideration for the moment the frailty and the fate of the man named Doe, there is another deduction from the story which is not unimportant. If one thinks of the client in the case, some fruitful thoughts arise. For instance, if the client wanted an accountant who would not be over-scrupulous he obviously wanted someone who would help him to perpetrate an act which had something doubtful about it. Why, then, did he engage the services of Mr. Smith and put up with his protests and whims when presumably he could always have enjoyed the more congenial society of Mr. Doe? The answer to the question is not far to seek. Most men like to be honest and to move in honest company when it does not entail too much sacrifice. While there was not urgent need for silence, therefore, the outspeaking Mr. Smith was acceptable. The next question is this: How did the president of the corporation know that he could approach Mr. Doe with such a proposal? What made him run the risk of being kicked downstairs? As to that, who knows? There is an underground transmission of information which somehow tells the crooked and the almost crooked how to find the tools needed in their business. Probably if it were necessary to discover the whereabouts of a cheap and quick executor of murders it could be done by mixing awhile in the society where murder is the mode. So if a business man wanted to know how to be a shilly-shallier or something yet nastier, he could learn by participating in the ways and walks of the guild to which he sought initiation. So, too, a business man, who felt that he must have a signature of one who would sign on the dotted line without reading the superscription, could hear of such a man by consultation with some more hardened offender. The client who wants a conformant lawyer or accountant will find what he seeks if there be one available.

The Evil Way May Be Avoided

The third thought which the story promotes is a somewhat philosophic complacence. It is not worth while to worry about the iniquities of other people. The business man who complains because there is a bad accountant is not a discerning person. Why need he suffer distress because an accountant is crooked or perhaps only weak? He should rather rejoice that he has found out the facts and is able to steer clear of entangling alliances with such a malpractitioner. If the man of business is as shrewd as he thinks himself to be he can distinguish the good and the bad. He wants only the good—well, then, why not engage the kind of professional man he needs and give up his inclination to deplore the conditions which he has revealed? It is certainly absurd for any man to grow fretful about evils which he can readily circumvent. That is sound logic up to a point. The business world need not greatly concern itself about the shortcomings of the professions. If business will forever abstain from the employment of weak and willing slaves, they will starve to death or be driven into some worthier calling. Business men, like everyone else, get pretty much what they deserve. Instead of raising hands to heaven at the wickedness of the professions, it would be far more creditable and also more effective if the wickedness in business were the cause of wailing. Let business men consider their peers who err. It will keep their energies employed for quite a while. But the professions have a great task, too.

Some Evils Should Be Exposed

Such a disgusting case as that which has given rise to the present comments is enough to dishearten the best friends of progress. It is altogether discouraging to hear that there is any man calling himself an accountant who has so lost his sense of honor that he can be led by the mere love of money—there is no other imaginable excuse for such perfidy—to agree in advance to sign whatever may be placed before him for signature. Someone may say, "Perhaps this is so, but why discuss it? It is better to let silence breed forgetfulness in this case." That might be the easiest way, but it does not seem that reform can be advanced by a dead hand. We have always labored under the firm conviction that it is better to call a lie a lie and a crook a crook than it is to say nothing at all. There is far too much inclination to sickly silence, and it is to be hoped that accountants will have none of it. The incident which we are considering is useful to point a moral. There may be some circumstances surrounding it which would be urged in defense of the supposed culprit, but it is difficult to think of anything which could justify the alleged agreement. On the face of it and so far as one can see behind the face, there is nothing but turpitude.

Terminology Department

CONDUCTED BY THE SPECIAL COMMITTEE ON TERMINOLOGY OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

[NOTE:—The special committee on terminology submits its tentative definitions for the consideration and criticism of readers of the JOURNAL. Comments will be welcome. Letters may be addressed to the committee in care of THE JOURNAL OF ACCOUNTANCY.]

"Balance-sheet—pro forma" was defined by the committee in 1923 as "A balance-sheet containing suppositious headings and sometimes figures, used as a basis for illustrating a principle or for other purposes."

This definition covered the case at that time, but as the profession advances new words are coined and new meanings are given to old words to meet the fresh requirements—a sure sign of life.

Among such new meanings the committee finds that the expression "pro forma balance-sheet" as used in financial circles has acquired for itself a new meaning, and the following definition is submitted:

PRO FORMA BALANCE-SHEET:

A special technical meaning is being given to this term, and has been so far accepted and used by bankers and accountants that, notwithstanding its philological faults, it seems likely to become fixed in the accounting terminology. It means a balance-sheet, based on audit of existing accounts, and giving retroactive effect to financing, mergers, consolidations or contracts that have either been consummated after the date of audit but before the actual preparation of the balance-sheet, or, though not yet consummated, are covered by binding contracts made with responsible parties. Such balance-sheets may be certified.

DIVIDENDS ON PREFERRED STOCK:

The rights of preferred stock have attracted so much attention of late, owing to two important decisions which are, on the surface, contradictory, that the committee feels warranted in dealing with the subject.

In the case of the Southern Railway the supreme court of appeals of Virginia sustained the judgment of the lower court, which had held that if directors in good faith failed to declare dividends on preferred stock, when the earnings were sufficient, and used those earnings for other corporate purposes the stockholders could not claim such dividends.

In the case of the Wabash Railway, the U. S. circuit court of appeals held that in such circumstances the earnings of each year, if sufficient, constituted a dividend credit which at some future time might be paid, and the court held that no dividends could be paid on any junior stocks until these earned dividends had been paid on the non-cumulative preferred stock.

The difference between these decisions is due entirely to the differences in the charters. The Wabash charter provides that these preferred stockholders shall be *entitled* to specified dividends when earned, while the charter of the Southern Railway carefully leaves the rights of the holders of preferred stock to be determined at the discretion of the directors. The non-cumulative Wabash stock was not fully non-cumulative, but had a limited degree of cumulative right.

A letter recently received from one of the institutions devoted to the teaching of higher accountancy leads the committee to feel that its labors have not been entirely in vain, for it comes from a professor who expresses interest in the work and makes a valuable suggestion.

The writer expresses himself as follows:

> "When a series of definitions is published as in the December number of THE JOURNAL OF ACCOUNTANCY, I presume they are intended to include all accounts that come from a single idea. Thus the idea of dividends causes the existence of several different accounts. I suppose that the dividend definitions in the December JOURNAL are intended to include all dividend accounts."

The committee regrets to say that the correspondent's presumptions are premature and that his suppositions are too optimistic. It has been found impossible always to include in one issue of the JOURNAL all technical terms relating to a given idea. Sometimes limits of space preclude the publishing of an entire group in one number; sometimes we find that, notwithstanding a microscopic search, some words have been omitted, e.g., "Dividends—declared." However, the usual cause for such omissions is the method pursued by the committee. The practice is to prepare a list of related words, such as "dividends" and the derivations, and to send this to one member who sketches the definitions. These sketches are sent to the other committee-men who approve, amend or disapprove each definition. In the case of disapproval, discussion ensues and unanimity may not be effected in time for publication in the forthcoming issue of the magazine. Many such words are now under consideration.

The correspondent calls attention to the omission of "Dividends—payable" which, oddly enough, is due to the second cause mentioned above. The following is suggested:

DIVIDENDS—PAYABLE:

Dividends which have been declared and for which means of payment are available. Such dividends form a current liability.

The correspondent refers to the absence of a definition of "Reserve for bad debts." In return, the committee begs to refer him to the issues of the JOURNAL appearing in October, 1922, and in August, 1928, in each of which this term is discussed.

The committee hopes that it may soon be possible to publish in pamphlet form the tentative definitions which have appeared during the past six or seven years.

Another correspondent writes as follows:

> "Your January, 1929, edition, page 53, explains: 'Statement of financial condition: In accounting this is a statement of assets and liabilities, in which special attention is given to the relation of current assets to current liabilities.' The dictionary defines a statement to be a summary of facts; financial as relating to monetary affairs; condition, the state in which a thing *exists:* the balance-sheet as 'A statement in tabular form to show assets and liabilities, profit and loss.' Executives often refer to a balance-sheet as a schedule of open accounts, or a list of quantities, signifying a remainder. I suggest that 'statement of financial condition' replace the incongruous expressions 'statement of affairs' and 'balance-sheet.'

> Statement of current assets and liabilities is, per se, an adequate title. Accounts receivable consist of customers' accounts; therefore use the self-explanatory term. Likewise the caption 'accounts payable' is better denoted 'creditors' accounts.'"

This letter brings out some points which have not been enlarged upon by the committee:

(1) If the technical meanings of terms used by accountants were to be found in a dictionary, the work of the committee would be unnecessary and useless.

(2) While the members of the committee have been in practice for many years in many places, no one of them has had such experience as would lead him to say that "Executives often speak of a balance-sheet as a schedule of open accounts."

(3) The committee is unable to see any incongruity in the expressions "statement of affairs" and "balance-sheet." The term "balance-sheet" is so firmly established that it is impossible and undesirable to attempt to abandon it. The inadequacy of the expression suggested is evident on remembering that a balance-sheet shows capital and surplus which are not usually considered assets or liabilities and, very frequently, it shows both assets and liabilities which are not current.

(4) "Accounts receivable" and "accounts payable" are generic terms and unless qualified may properly include items not due by or to customers.

(5) The province of the committee is to give the present technical meanings of accounting terms, as used in the best accounting practice, not to attempt to dictate new and strange terms, no matter how desirable they may appear. If the terms advocated by this correspondent had been in general use the committee would have been glad to define them; but they are not in common use.

Income-tax Department

EDITED BY STEPHEN G. RUSK

"Profit from the sale of municipal bonds is exempt from income tax, such tax being either on the bonds themselves or on the income arising therefrom," is the language used by Judge Cant of the United States district court, district of Minnesota, third division, in the case of *Bunn* v. *Willcuts, collector*.

This decision must be good news to a large body of taxpayers who have been under the impression that only interest derived from the obligations of a state, territory or any political subdivision thereof, or the District of Columbia, is exclusible from gross income for federal income-tax purposes. To the writer, also, is it news, and he remembers with chagrin that he has advised his clients on numerous occasions that whereas interest on such obligations need not be included in gross income, any loss sustained or any profit earned on the sale or other disposition of such securities was properly includible in the elements comprising taxable income.

The judge's opinion sounds reasonable enough when he states that a tax on a profit from the sale is exempt from taxation, such tax being either on the bonds or on the income derived therefrom, but if he is right, it seems a bit strange that congress permitted the exclusion from gross income of only the interest on such securities.

Furthermore, the question immediately arises as to whether or not those financial houses the major part of whose income is derived from the purchase and sale of state, county, municipal bonds, etc., should have paid income taxes on the profits so earned.

A brief statement of the court's opinion is ventured in the following paragraphs:

1. The means and instrumentalities of a state government are exempt from taxation.
2. This principle is not based upon any constitutional provision. It rests on necessary implication.
3. It also covers income arising from such obligations.

(Conclusion):
It is, therefore, beyond dispute that income from bonds such as those here in question is not subject to a tax under the revenue law.

Further along, the court states it to be an underlying principle that the government shall not exercise the power of taxation in such manner as in any substantial degree to interfere with the state in any of its governmental functions.

The court is of the opinion that should the investing public know that any gain or profit realized from a rise in value of such bonds would be subject to a federal tax, this would operate to discourage the public from dealing in such securities and would cause a reduction in the prices which persons would be willing to pay therefor.

Even though one might prefer to believe with the court that a profit from the sale of such securities should be exclusible from the gross income and, therefore, not subject to a tax, the fact that there is a marked difference between income arising from the possession of such securities and that derived from buying and selling such securities causes some doubts to linger in one's mind. Furthermore, it seems doubtful if the taxing of income derived from the sale of such securities "in any substantial degree interferes with the state in its governmental functions."

Final decision of this case will be awaited with much interest.

A belated decision with respect to invested capital reduction, under the 1918 act, by reason of a tentative tax computed on the income for that year in determining the amount of current earnings available for payment of dividends, was rendered by the United States circuit court of appeals for the third circuit. This decision, if it had been rendered in any year between 1918 and 1924, would have saved taxpayers in those years some taxes. The Pittsburgh Knife and Forge Company, in whose case the decision was recently made, evidently did not agree with the commissioner's theory upon the subject, and was persistent enough to contend through years of litigation for that which it deemed to be proper.

Tax practitioners are familiar with the theory underlying this decision, wherein it was held by the commissioner that unless current earnings of a corporation were sufficient to cover a dividend paid during the year, invested capital must be reduced by the amount by which the dividend exceeded current earnings up to the date the dividend was paid. In arriving at current earnings, the commissioner insisted that the income tax on current earnings should be deemed to reduce the earnings available for dividend purposes. Most of the tax practitioners argued at the time that the income tax was not a liability of the current year, and, therefore, it should not be applied as a reduction of corporate net earnings of the current year. At last, these practitioners are justified, but to many of them there is little satisfaction in being proved correct at this late date.

RECENT RULINGS

The beverage tax imposed upon a manufacturer of soft drinks which had notified its customers that the price included the amount of tax imposed by sec. 628 of the act of 1918, should be computed on the full price received where he failed to bill the tax separately as required by the regulations. (Supreme court of the U. S. *Lash's Products Company* v. *United States.*)

Profit derived in 1917 and 1918 by a lessor of mining properties is the fair cash value on March 1, 1913, of the tonnage mined in such years, less the interest carrying charge of 5% from March 1, 1913, to the taxable years. (U. S. circuit court of appeals, seventh circuit, *Mabel G. Reinecke* v. *Collector.*)

The date of allowance of a credit is the date when the commissioner signed the "Schedule of overassessments and allowance of abatements, credits," etc., for transmission to the collector containing his authorization to apply overpayments of tax as a credit against taxes due, if any, and, where such allowance was made prior to the effective date of the 1926 act, the taxpayer is entitled to interest upon overpayments for the fiscal year 1918 from the date of such overpayment until the date of an additional assessment for the fiscal year 1919, against which such overpayment was credited, under sec. 1019 of the 1924 act. (District court of the U. S., western district of Pennsylvania. *Penn Smokeless Coal Co.* v. *United States.*)

Six corporations were held to be affiliated for 1920 where 71% of three corporations, 78% of a fourth and over 95% of a fifth were owned by the sixth corporation or its organization, which controlled other stock through agreements that the stock of the minority stockholders was to be offered for sale to the parent company first, and through proxies, and the companies were guided by a common interest and a common object obtained by pursuing the same methods through the same agencies. (U. S. circuit court of appeals, seventh circuit, *The Great Lakes Hotel Co.* v. *Commissioner.*)

Profit from the sale of municipal bonds is exempt from income tax, such tax being either on the bonds themselves or on the income arising therefrom. (U. S. district court, third division of Minnesota, *Chas. Bunn* v. *Collector.*)

Profit from the sale in United States of goods manufactured abroad by a foreign corporation is gross income from sources within the United States within the meaning of sec. 233(b), act of 1918. (U. S. circuit court of appeals, second circuit, *Tootal Broadhurst Lee Company, Ltd.*, v. *Commissioner.*)

Amount designated "bankers' commissions" paid in 1918 was held to be the purchase price of stock representing ownership in a fumigating plant and not a deductible expenditure in the nature of interest. Such amount was paid under an arrangement between the taxpayer and certain bankers by which the latter agreed to furnish the funds for the construction of such plant in consideration of the repayment of their advances plus a lump sum to be paid out of the earnings of the plant, which arrangement was carried out by the organization of a new corporation to which the bankers transferred the plant for stock plus cash equal to the organization shares and an agreement to repay the amounts expended for the plant, and the transfer of the stock of the new corporation to the taxpayer for the lump sum which was paid out of dividends of the new corporation. (District court of the U. S., district of Massachusetts, *Wiggin Terminals, Inc.*, v. *United States.*)

Appeal from an order of the supreme court of the District of Columbia granting a temporary injunction restraining the collection of a tax barred by the statute of limitations was dismissed as premature, without passing on the merits of the case, such interlocutory injunction not being appealable, under the law, since it did not affirmatively change nor affect the possession of property. (Court of appeals, District of Columbia, *Andrew W. Mellon, sec'y. of treasury*, v. *Edward P. Mertz.*)

Amount paid by a lessee out of royalties accruing after a specified date from an undivided interest in an oil well under a compromise agreement between such lessor and another claiming title to the land adversely to that of the lessor's grantor providing for the payment to the adverse claimant of a stated amount out of the royalties to be received and the relinquishment by the party claiming title to the land of his adverse claim to such lessor's right to receive royalties, is not part of the lessor's gross income, since the ownership thereof vested in another when they accrued. (U. S. circuit court of appeals, fifth circuit, *United States* v. *Frank J. and Mrs. Frank J. Looney.*)

Sec. 611, act of 1928, is no defense to the collector in a personal action against him for the recovery of 1918 taxes collected June 7, 1926, under duress after the expiration of the statutory period on collection and when the liability therefor had been extinguished where a claim for abatement had been filed and rejected October 6, 1921, and the commissioner had thereafter granted special assessment, such section not being a specific retroactive ratification of an illegal collection by the collector as agent. (District court of the U. S., western district of Pennsylvania, *Clinton Iron & Steel Co.* v. *D. B. Heiner, collector.*)

Dividends received in 1917 by the executors of an estate on stock specifically bequeathed before such legacies were paid are income received by an estate during administration taxable as an entity to the estate under sec. 2(b), act of 1916, as amended, at the 1917 rates. (U. S. circuit court of appeals, first circuit, *Clarence M. Woolley, et al., executors*, v. *John F. Malley, former collector.*)

Income received by the executors of an estate in 1917 from the residuary estate the income of which was to be distributed to certain beneficiaries, before it had been transferred to trustees for beneficiaries as provided by the will, is assessable to the executors as income received during the period of administration of the estate, at the rates imposed upon executors as taxable persons under sec. 8(c), act of 1916 as amended. (U. S. circuit court of appeals, first circuit, *John F. Malley, former collector*, v. *Clarence M. Woolley, et al.*)

Section 615, act of 1928, amending sec. 177 of the *Judicial Code*, as amended, is not retroactive, and interest on a judgment for the recovery of a tax rendered by the supreme court in 1927 is allowable under sec. 1117, act of 1926, amending sec. 177 of the *Judicial Code,* to the date of entry of the final judgment. (U. S. court of claims, *The S. S. White Dental Mfg. Company of Pennsylvania* v. *United States.*)

Liability for breach of a contract as established by a judgment rendered in a subsequent year is deductible in the year of the breach by a taxpayer on the accrual basis who set up on its books a reserve for such liability in the year of the breach, such liability being created by the breach of the contract, and not by the admission of liability therefor to the creditor. (U. S. circuit court of appeals, second circuit, *American Code Company, Inc.,* v. *Commissioner.*)

Income received in 1919 and 1920 by a trust and added to the corpus pursuant to a trust deed providing for distribution of the income thereof at the discretion of the trustee or upon demand by the majority of the beneficiaries, no demand for distribution having been made, is taxable to the trust as income held for future distribution. (District court of the United States, western district of Missouri, *C. S. Jobes, trustee of C. S. Jobes Trust Estate,* v. *Noah Crooks, collector.*)

Contract held to be a licence for the use of a secret process and not a sale of such process, and the payments received under it are income and not a realization of capital. (U. S. court of claims, *Charles E. Kaltenbach* v. *United States.*)

Invested capital for 1918 should not be reduced on account of a tentative tax computed upon income for that year in determining the amount of current earnings available for the payment of dividends. (U. S. circuit court of appeals, third circuit, *Commissioner of internal revenue* v. *Pittsburgh Knife & Forge Co.*)

Payments to cover expenses and losses incident to the sudden cessation of work on government contracts and return to the regular line of manufacture received under supplemental agreements canceling war contract should be offset by expenditures necessary to effect resumption of peace-time activities. The taxpayer's proof as to such expenses and losses, which could not be segregated on its books, consisting of the uncontradicted testimony of its vice-president in charge of the negotiation with the government and the reconstruction of the plant, stricken out in the hearing before the board of tax appeals on the ground that the books were the best evidence, and was held to be adequate. The board erred in holding in B. T. A. Dec. 2776, 7 B. T. A. 1277, noted at Par. 3311.06a, Vol. II, that any part of the payments received under the supplemental agreements should be subject to the higher rates of sec. 301(c), act of 1918, and the decision was reversed and remanded. (U. S. circuit court of appeals, second circuit, *R. Hoe & Co., Inc.,* v. *Commissioner.*)

Contributions in 1921 to the Y. M. C. A., the Y. W. C. A. and to a hospital are not deductible as ordinary and necessary business expenses by a corporation. (U. S. court of claims, *Alfred J. Sweet, Inc.,* v. *United States.*)

Students' Department

H. P. Baumann, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

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

Examination in Accounting Theory and Practice—Part II (*continued*)

November 16, 1928, 1 P. M. to 6 P. M.

The candidate must answer the first three questions and two other questions.

No. 2 (18 points):

On December 31, 1927, the ledger balances of Smith, Brown and Jones—a partnership, each member having a one-third interest therein—appeared as follows:

Cash	$9,500	
Receivables	98,500	
Reserve for bad accounts		$3,000
Payables		38,500
Loan from Jones		4,500
Salary due Smith		3,000
Capital:		
Smith		25,000
Brown		14,000
Jones		20,000
	$108,000	$108,000

At this date the firm decided to liquidate and a trustee was appointed to wind up its affairs.

The following represents the results of the trustee's activities:

Particulars	1st period	2nd period	3rd period
Cash collected from customers	$56,000	$18,000	$17,500
Liabilities paid in full settlement	19,200	19,000	
Trustee's expenses and salary	2,200	1,400	2,000
Cash paid to partners	8,000	9,900	Remainder

Prepare the necessary entries to wind up the partnership, and also prepare a statement setting forth the proper distribution (in your opinion) of the amounts paid to each partner at the end of each period and showing the final result.

Solution:

The statements required in this problem begin with the statement of partners' capitals on page 227.

SMITH, BROWN AND JONES
Statement of partners' capitals
From December 31, 1927, to ———, 1928

			Jones		Smith		Brown	
		Payables	Loan	Capital	Salary	Capital	Capital	Total
Balances at December 31, 1927		$38,500.00	$4,500.00	$20,000.00	$3,000.00	$25,000.00	$14,000.00	$105,000.00
Trustee's expenses paid—first period				733.33		733.33	733.34	2,200.00
Balances, after trustee's expenses		$38,500.00	$4,500.00	$19,266.67	$3,000.00	$24,266.67	$13,266.66	$102,800.00
Distribution of cash—first period—								27,200.00
Payables		19,200.00						
Loan of Jones			4,500.00					
Salary of Smith					3,000.00			
Balance to Smith on account						500.00		
Balances at end of first period		$19,300.00		$19,266.67		$23,766.67	$13,266.66	$75,600.00
Trustee's expenses paid—second period				466.67		466.67	466.66	1,400.00
Balances, after trustee's expenses		$19,300.00		$18,800.00		$23,300.00	$12,800.00	$74,200.00
Distribution of cash—second period—								28,900.00
Liabilities	$19,300.00							
Settled for	19,000.00	19,000.00						
Credit partners	$300.00	300.00		100.00*		100.00*	100.00*	
Cash to partners				2,700.00		7,200.00		
Balances at end of second period				$16,200.00		$16,200.00	$12,900.00	$45,300.00
Trustee's expenses paid—third period				666.67		666.67	666.66	2,000.00
Balances, after trustee's expenses				$15,533.33		$15,533.33	$12,233.34	$43,300.00
Loss on realization—								4,000.00
Receivables at December 31, 1927	$98,500.00							
Less: Reserve for bad accounts	3,000.00							
Book value	$95,500.00							
Amount realized	91,500.00							
Loss	$4,000.00			1,333.33		1,333.33	1,333.34	
Balances				$14,200.00		$14,200.00	$10,900.00	$39,300.00
Final distribution of cash				14,200.00		14,200.00	10,900.00	39,300.00

SMITH, BROWN AND JONES

Statement of partners' capital accounts

Working papers

First period:	Jones	Smith	Brown	Total
Profit and loss ratio	1/3	1/3	1/3	
Total assets to be realized				$98,500.00
Less: Reserve for bad accounts				3,000.00
Balance at December 31, 1927				$95,500.00
Deduct: Assets realized				56,000.00
Total possible loss	$13,166.67	$13,166.67	$13,166.66	$39,500.00
Partners' capital accounts	19,266.67	24,266.67	13,266.66	56,800.00
Excess of partners' capital accounts over possible loss	$6,100.00	$11,100.00	$100.00	$17,300.00

Inasmuch as the capital accounts of both Jones and Smith are sufficient to absorb their respective shares of any possible loss on the balance of uncollected receivables, the loan and salary accounts may be paid immediately.

The $500 remaining after the payment of the loan and salary accounts may be paid to Smith as the amount of his capital account is the largest.

Second period:	Jones	Smith	Brown	Total
Total possible loss at end of first period				$39,500.00
Deduct: Assets realized				18,000.00
Balance				$21,500.00
Deduct: Gain on liquidation of payables				300.00
Total possible loss	$7,066.67	$7,066.67	$7,066.66	$21,200.00
Partners capital accounts	18,900.00	23,400.00	12,900.00	55,200.00
Excess of partners' capital accounts over possible loss	$11,833.33	$16,333.33	$5,833.34	$34,000.00

It will be seen from these working papers that the capital accounts are in excess of the total possible loss. The payment of $9,900 is applied against the accounts of Jones and Smith, which contain the largest balances.

Entries to wind up the partnership

Entries for first period:

(1)

Cash	$56,000.00	
Receivables		$56,000.00

To record the cash collected from customers.

(2)

Payables	19,200.00	
Cash		19,200.00

To record the payment of liabilities.

(3)

Smith—Capital	$733.33	
Brown—Capital	733.33	
Jones—Capital	733.34	
Cash		$2,200.00
To record the payment of trustee's expenses and salary.		

(4)

Loan from Jones	4,500.00	
Salary due Smith	3,000.00	
Smith—Capital	500.00	
Cash		8,000.00
To record cash paid to partners.		

Entries for second period:

(5)

Cash	$18,000.00	
Receivables		$18,000.00
To record the cash collected from customers.		

(6)

Payables	19,000.00	
Cash		19,000.00
To record the payment of liabilities.		

(7)

Payables	300.00	
Smith—Capital		100.00
Jones—Capital		100.00
Brown—Capital		100.00
To record the adjustment in payables—paid in full.		

Balance per books	$19,300.00
Cash paid	19,000.00
Excess	300.00

(8)

Smith—Capital	466.67	
Jones—Capital	466.66	
Brown—Capital	466.67	
Cash		1,400.00
To record the payment of trustee's expenses and salary.		

(9)

Smith—Capital	7,200.00	
Jones—Capital	2,700.00	
Cash		9,900.00
To record cash paid to partners.		

(10)

Entries for third period:

Cash	$17,500.00	
Receivables		$17,500.00
To record the cash collected from customers.		

(11)

Smith—Capital	1,333.33	
Brown—Capital	1,333.33	
Jones—Capital	1,333.34	
Reserve for bad accounts	3,000.00	
Receivables		7,000.00

To write off loss on uncollected accounts:

Balance, December 31, 1927	$98,500.00
Less: Collections	91,500.00
Balance	$7,000.00
Less: Reserve for bad accounts	3,000.00
Loss to partners	$4,000.00

(12)

Smith—Capital	666.67	
Brown—Capital	666.67	
Jones—Capital	666.66	
Cash		2,000.00
To record the payment of trustee's expenses and salary.		

(13)

Smith—Capital	14,200.00	
Brown—Capital	10,900.00	
Jones—Capital	14,200.00	
Cash		39,300.00
To record final distribution of cash to partners.		

No. 4 (15 points):

The X Y Z Light & Power Co. has an operating contract with the trustees of a bond issue, under the terms of which it must expend seven per cent. of its gross operating revenue for maintenance. Any portion of the seven per cent. not so expended must be deposited with the trustees.

Under the terms of the same contract, the company must set aside annually a reserve of four per cent. of its gross operating revenue for depreciation.

A certain built-in production unit has fallen below a profitable degree of efficiency and must be either rebuilt or replaced by a new unit.

It is decided to re-build which involves three steps, viz.:—(1) tearing down, (2) repairing certain parts, (3) re-erecting. Tearing down is done at the cost of labor only. Repairing parts requires the purchase of necessary material and entails cost of labor. Re-erecting involves principally cost of labor and incidental material.

(a) Is any part of the cost involved in the above process chargeable to maintenance or maintenance reserve? If so, designate what part and explain why.

(b) Is any part of the cost involved chargeable to depreciation reserve? If so, what part and why?

(c) Is labor cost a proper charge to depreciation reserve?

(d) Does the expenditure of money for labor retard the progress of depreciation or is that function performed only by material?

Solution:

(a) Maintenance expenditures are classified generally as those repairs of minor consequence which occur with somewhat regular frequency and keep a machine or unit in operation. The expenditures may be charged currently as incurred, or against a reserve for maintenance if the company has created and is operating such a reserve. The primary purpose of such a reserve is to apportion the cost of maintenance (upkeep) over the periods during which the machine or unit is used. In the present case, the unit had fallen below a profitable degree of efficiency and "*must* be either *rebuilt* or *replaced* by a new unit". Therefore, no part of the cost of (1) tearing down, (2) repairing certain parts or (3) re-erecting should be charged as maintenance but to the reserve for depreciation.

(b) After rebuilding the unit, the company had added nothing to its equipment, but had converted an unprofitable unit, which had evidently run down or had become obsolete, to one of efficient operation with additional years of service. In the circumstances, the generally accepted theory of charging the cost to the reserve for depreciation should be followed.

(c) Labor cost is a proper charge to depreciation reserve if the labor retards or arrests depreciation or in itself or in conjunction with material prolongs the life of the asset beyond the originally estimated period.

(d) Labor may retard the progress of depreciation. Maintenance of the roadbed of a railroad frequently involves only a labor expenditure, as when a track crew is employed in shifting ballast and rearranging ties, rails, etc. Material does not arrest depreciation unless applied, by means of labor, to the machine or unit subject to depreciation.

NOTE.—In public-utility accounting, considerable difficulty is encountered in distinguishing between maintenance and depreciation expenditures. The operating contracts which the company had with the trustee, and the rules and regulations of any supervising commissions should be read for any provisions pertinent to the case in point.

No. 5 (15 points):

The Plebe Machine Company operates under a licence from the Omnia Corporation, the owner of certain patents. In terms of the licence agreement the company agrees to pay the corporation a royalty of five per cent. of the net sales price of all machines sold each year during the continuance of the licence. Royalty settlements on the five per cent. basis are to be made quarterly—March 31st, June 30th, September 30th and December 31st, and it is agreed that a minimum royalty of $120,000 shall be payable for each of the calendar years covered by the licence.

During the half year ended June 30, 1928, the net sales aggregated $700,000 and royalty amounting to $20,000 was paid thereon, i. e., royalty for the March quarter. The company's business is seasonal and it is claimed by the management that royalty for the calendar year, calculated on the agreed-upon basis of five per cent. of the net sales, will at least equal the stipulated minimum of $120,000.

The Plebe Company's fiscal year ends on June 30th.

State what amount you would show in the balance-sheet as the liability for royalty at the date named. Give reasons for your answer.

Solution:

Under the terms of the licence the Plebe Manufacturing Company was required to pay the Omnia Corporation 5 per cent. of the net sales which for the six months ended June 30, 1928, amounted to $700,000. The amount of the royalties for the six-months period was, therefore, 5 per cent. of $700,000, or $35,000. Of this amount, the Plebe Manufacturing Company had paid $20,000, leaving a balance due of $15,000 as at June 30, 1928. This amount represents an actual liability as at that date and should be shown as a current liability in the balance-sheet.

It was further agreed that a minimum royalty of $120,000 "shall be payable for each of the calendar years covered by the licence". Any actual liability arising under this clause can not be determined until at the end of each calendar year. However, the accountant should give expression to the contingent liability thereunder, by means of a footnote on the balance-sheet as at June 30, 1928, if no surplus is set aside as a reserve for such contingency.

No. 6 (15 points):

The following are the comparative profit-and-loss accounts of the Deka Company for the two years ended December 31, 1926, and December 31, 1927, respectively:

	Year ended December 31, 1926	1927	Increase
Net sales	$1,000,000	$1,250,000	$250,000
Cost of sales	800,000	975,000	175,000
Gross profit	$200,000	$275,000	$75,000
Selling expenses	$70,000	$75,000	$5,000
General and administrative expenses	40,000	45,000	5,000
Total expenses	$110,000	$120,000	$10,000
Net profit on sales	$90,000	$155,000	$65,000
Other income:			
Interest on notes receivable	$5,000	$7,000	$2,000
Gross income	$95,000	$162,000	$67,000
Deductions from income:			
Interest on notes payable	6,000	10,000	4,000
Net income	$89,000	$152,000	$63,000

Prepare a statement accounting for the increased net income, showing the amounts due to the variation in the volume and selling prices respectively, assuming that the cost of goods was the same in both years.

Solution:

THE DEKA COMPANY

Statement accounting for increase in net profit

Net profit—1927	$152,000.00
Net profit—1926	89,000.00
Increase in net profit	$63,000.00

Accounted for as follows:				
Items increasing net profit:				
Increase in gross profits, caused by:				
(1) Increase in volume of sales:				
Sales in 1927, at 1926 prices (see below)...	$1,218,750.00			
Sales 1926..	1,000,000.00			
20% (1926 rate of gross profit) of.......	$218,750.00	$43,750.00		
(2) Increase in rate of gross profit, due to:				
Increase in selling prices				
Sales—1927—actual	$1,250,000.00			
Sales—1927—at 1926 prices..	1,218,750.00	31,250.00	$75,000.00	
Increase in interest on notes receivable:				
1927........................		$7,000.00		
1926........................		5,000.00	2,000.00	$77,000.00
Items decreasing net profit:				
Increase in selling expenses:				
1927........................		$75,000.00		
1926........................		70,000.00	$5,000.00	
Increase in general and administrative expenses:				
1927........................		$45,000.00		
1926........................		40,000.00	5,000.00	
Increase in interest on notes payable:				
1927........................		$10,000.00		
1926........................		6,000.00	4,000.00	14,000.00
Increase in net profit (as above).......				$63,000.00

Computation of selling prices and costs of 1927 business on 1926 basis:

Cost of sales—1927.................................. $975,000.00

On the assumption that the cost of goods was the same in both years, these goods would have cost $975,000.00 in 1926.

Sales—1927.................................... $1,250,000.00

The write up in 1926 was 25% on cost with the result that the profit on sales for that year was 20%. Then the goods sold in 1927 would have been written up in 1926 to $975,000.00 × 125% or $1,218,750.00 which would have been the selling price in 1926.

Correspondence

WHAT ARE NET PROFITS?

Editor, The Journal of Accountancy:

SIR: Speaking of a letter from a correspondent printed in your issue of January, 1929, you say that some readers may care to exercise their ingenuity and display their wisdom by attempting to reply.

Not ingenuity but ingenuousness, not wisdom but simplicity and candor are needed.

The quotation from *The Accountant* says, in part, "Thus the 'net profits' of a company were described in *Lambert* v. *Neuchatel Asphalte Co.*, etc." That definition, in rather clumsy legal verbiage, is fairly correct. It is not a definition of "net profits," but of "net profits of a company"—and the definition means something although the two words "net profits" by themselves were truly just two words.

Similarly, in *Frances* v. *Butlfontein Mining Co.*, where "the articles of a company provided a percentage to the directors on the 'net profit' of each year," the term was held to mean "the net profits made by the company as a going concern, but did not comprise a profit made by the sale of the whole undertaking and assets." The percentage to the directors was not said to be a percentage on "net profit" but on "net profit of each year." The profit on sale of the business was not a profit of the year when sold, but was goodwill, etc., accumulated over the whole life of the business, definitely ascertained only on sale. True, American tax laws consider such profit as taxable in the year when it is realized; but accounting under our tax laws is an arbitrary device for the assessment of taxes. Would your correspondent include such a profit in an annual profit-and-loss account?

In any case the profit from the viewpoint of the company was the profit after paying the directors' percentage, so that the idea that in this case the profit to the company and the 'net profit of each year' for the purpose of computing directors' percentage could be the same is absurd. In prospectuses of reorganizations, where businesses are sold and the stock of the successor offered to the public, annual profits for a series of years are stated. The profit on sale is never included and if any promoter should try to include it he would be considered dishonest or demented.

Then, *in re British Columbia Co.*, "commission on net profits of stated contracts was construed to mean such profits as arose on each contract, minus only the expenses thereon, but not deducting anything on account of the general management of the company." Very proper; any cost of general management could be guessed at but not positively known, and no change could be made to a contract, unless specially provided in the agreements, in which the amount of the charge should be indicated.

This is the plan followed in contracts wherein a percentage of net profits on specified motion pictures is paid to actors or others; no charge for the general management of the distributing company is made; and the profit to the distributing company is after deducting the percentage payable to the actor. So far as the actor is concerned "net profit on the picture" means something quite different to the profit as viewed by the company. In all such cases the general management expense is chargeable against that part of the profit accruing to the company.

It is to be noted that in each case the words "net profits" were further qualified, the complete phrase being "net profits of a company," "net profits of each year," "net profits of stated contracts."

The partnership matter is less clear; in the absence of further information I would not care to comment on or endorse the decision.

Your correspondent implies that only a professional humorist could be expected to say that "a different meaning may competently be assigned to the same word or phrase although occurring in the same deed," and asks what an accountant should do when members of the privy council, judges, and a distinguished editor plainly tell us that English words are as changeable as a chameleon. If they did plainly tell him that I would suggest that he reply that they said the thing that was not. But they did not plainly tell him that, and only the editor said *anything that could be interpreted as hinting at it.*

Any two words, no matter how definite their meaning when standing alone, may have somewhat differing but not inconsistent meanings when qualified by further words within the phrase.

The childish wish for unmodifiable definitions of such terms and for rules for their use, to be applied blindly, is, I think, an indication of mental slothfulness. Effort to satisfy such a wish can affect our language only to its detriment.

Finally, every definition of "net profit" given agreed that net profit is the residue of income after applying to it all expenses that are properly to be so applied; but *The Accountant,* and your correspondent, have a quarrel only with the decisions as to what expenses are, in each case, chargeable against certain income—another instance of failure to distinguish between words and ideas.

Yours truly,

F. W. THORNTON.

Newark, N. J., January 9, 1929.

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