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CONTENTS

American Institute of Accountants Examinations, May, 1929 401

Benevolent Organizations and Their Accountability to Their Supporters 419
By CHARLES E. MATHER

Some Legal Aspects of Goodwill 429
By L. L. BRIGGS

Editorial 443
Dangerous Development of Corporation Laws — Protection for the Directors — Principle of No-par-value Stock Is Sound — Recent Changes Are Perilous — What the Accountant May Do About It — An Arkansas Law and the Accountant

Terminology Department 451

Income-tax Department 456
Edited by STEPHEN G. RUSK

Students' Department 459
Edited by H. P. BAUMANN

Book Reviews 470

Current Literature 476

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Authors of Articles in this Issue of THE JOURNAL OF ACCOUNTANCY

Charles E. Mather. Member, American Institute of Accountants. Certified Public Accountant (Minnesota, New Jersey, New York, Ohio). Member of firm, Stagg, Mather & Hough, New York.

L. L. Briggs. Assistant Professor of Economics, University of Vermont.

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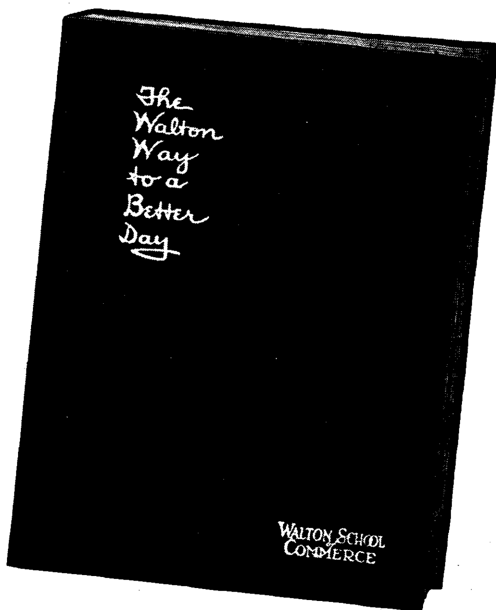

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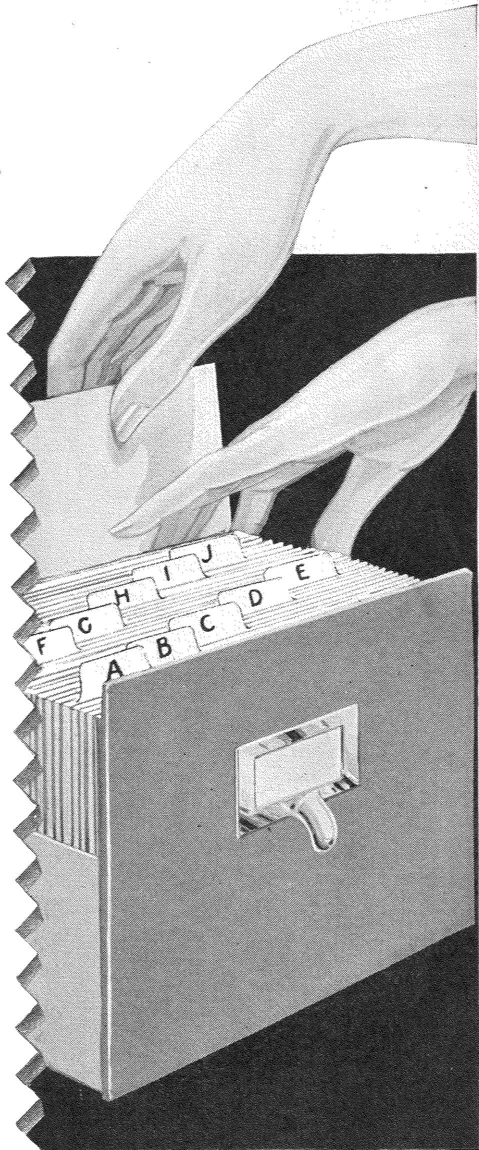

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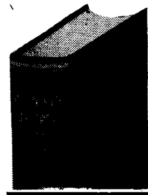

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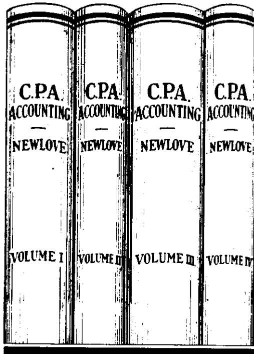

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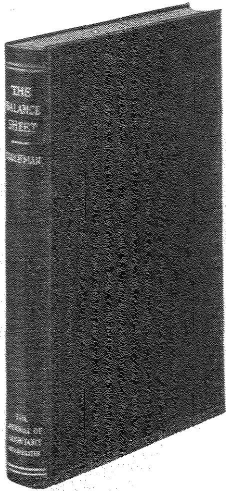

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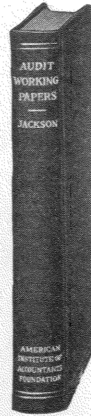

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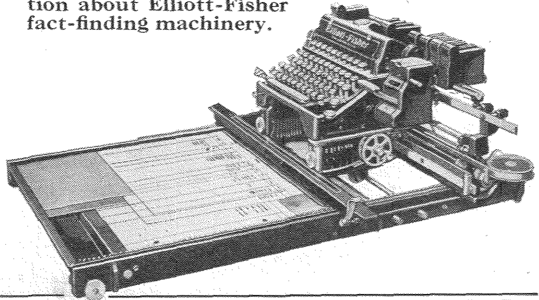

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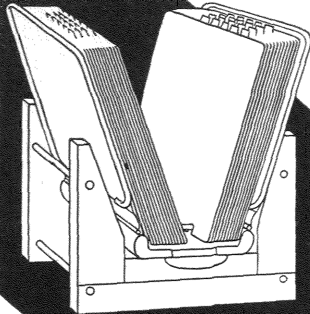
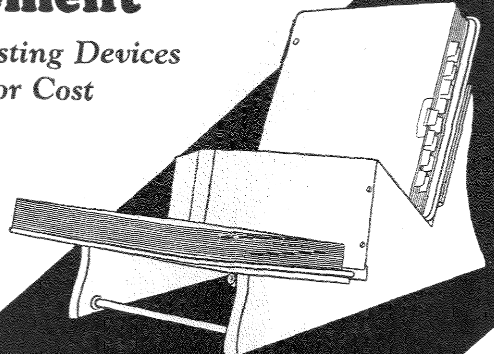
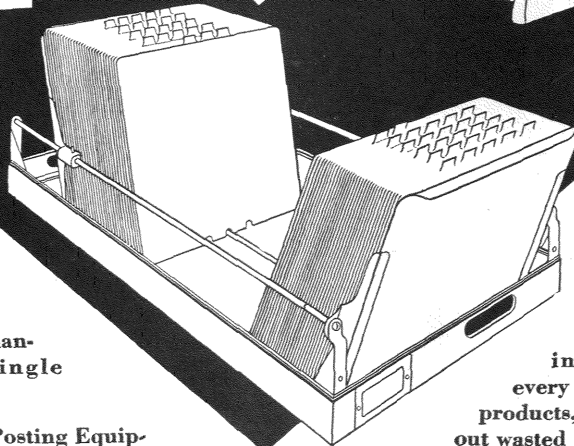

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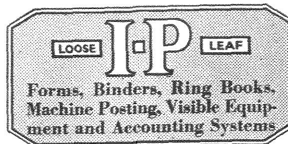

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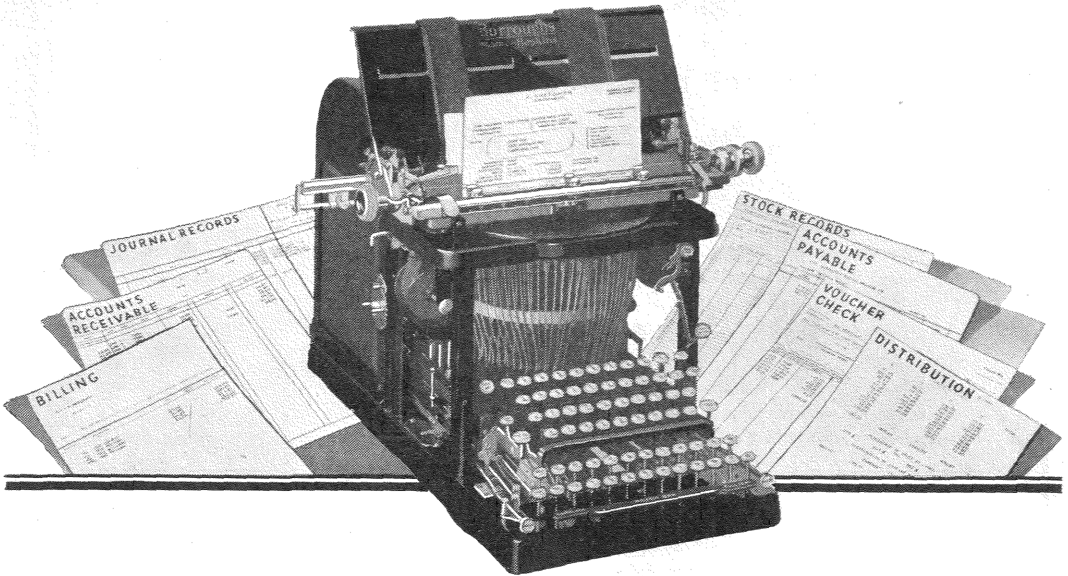

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On cash or check payments including extension of time tickets, etc.

Costs ☐
Figuring labor, material distribution, summaries, cost sheets, etc.

Pro-rating ☐
Of expense, payroll, costs, etc.

Accounts Receivable ☐
Ledger, statement and proof journal in combination—ledger and end of month statement—with or without typewritten description.

Sales Audit ☐
By clerks and departments, cash, charge and C. O. D.

Inventory ☐

Name ________ Firm ________ Address ________

ADDING · BOOKKEEPING · CALCULATING AND BILLING MACHINES

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AMERICAN INSTITUTE OF ACCOUNTANTS EXAMINATIONS

[Following is the text of the examinations in auditing, law and accounting presented by the board of examiners of the American Institute of Accountants May 16 and 17, 1929.]

Examination in Auditing

MAY 16, 1929, 9 A. M. TO 12:30 P. M.

The candidate must answer all the following questions:

No. 1 (5 points):

Define—

(a) Subsidiary corporation.
(b) Investment trust corporation.
(c) Holding company.
(d) Close corporation.
(e) Affiliated company.

No. 2 (12 points):

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

No. 3 (10 points):

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

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

No. 4 (6 points):

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

No. 5 (10 points):

The M company has outstanding its entire capital stock of one hundred thousand shares, $25 par, on which $12.50 per share has

been paid in, the balance remaining subject to call at the discretion of the directors. Since the business has proved highly profitable and a surplus of three times the capital stock has been accumulated, the directors wish to make the capital stock full-paid. Your advice is asked as to the best method of carrying out this purpose, with care for the financial interests of both the company and its stockholders. What would you advise? Give reasons.

No. 6 (9 points):

(a) Name the factors in determining an amount of depreciation.

(b) State to what extent each factor is ascertainable by the auditor.

No. 7 (15 points):

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

No. 8 (15 points):

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

A B Corporation

Balance-sheet, December 31, 1928

Assets

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

Liabilities

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

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

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

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

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

No. 9 (10 points):

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

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

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

No. 10 (8 points):

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

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

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

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

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

Examination in Accounting Theory and Practice

PART I

May 16, 1929, 1 p. m. to 6 p. m.

The candidate must answer the first four questions and one other question.

No. 1 (35 points):

Company C was formed, March 31, 1929, to acquire the interests of companies A and B by the purchase of their capital stocks as at December 31, 1928.

The balance-sheets of companies A and B, as at March 31, 1929, were as follows:

	Companies	
	A	B
Cash	$ 45,000	$ 15,000
Accounts receivable	235,000	28,000
Inventories	500,000	50,000
Land	50,000	10,000
Buildings	600,000	90,000
Machinery and equipment	900,000	190,000
	$2,330,000	$383,000

Accounts payable—trade	$ 90,000	$ 48,000
Bonds—8%	880,000	120,000
Capital stock—		
Preferred, 6%, cumulative (par value $100)	400,000	50,000
Common (par value $100)	840,000	24,000
Surplus—December 31, 1928	40,000	96,000
Profit—Jan. 1 to Mar. 31, 1929	80,000	45,000
	$2,330,000	$383,000

It was agreed that the fixed assets were stated on the balance-sheets at their sound values at December 31, 1928, and that depreciation rates for 1929 should be 2 per cent. per annum on buildings and 6 per cent. per annum on machinery and equipment.

The 8 per cent. bonds, on which interest had been paid to March 31, 1929, were to be retired at par out of the proceeds of $1,500,000 bonds to be sold March 31, 1929, by company C at 95.

A construction fund of $400,000 is to be established out of the proceeds of the new bond issue and the money is to be deposited with a trustee.

Preferred stock is to be exchanged, share for share, for preferred stock (par value $100) of company C. The common stock of company C is 12,000 shares (par value $100), all of which is to be issued to common stockholders of companies A and B according to their respective equities in the old companies. At March 31, 1929, the preferred stockholders of the old companies had not exchanged any of their stock for company C preferred, and 20 per cent. and 10 per cent. of the common stockholders of companies A and B, respectively, had not turned in their stock for exchange.

Federal income-tax returns for 1929 will be made upon a consolidated basis.

Dividends on the preferred stock of companies A and B were paid to December 31, 1928, and are guaranteed by company C to April 1, 1929.

Prepare a consolidated balance-sheet as at March 31, 1929, giving effect to the acquisition of companies A and B by company C and to the transactions described.

No. 2 (20 points):

Company A, an old established concern, wished to merge with and eventually acquire control of company B, a relatively new enterprise (incorporated, 1922).

The status of these companies at December 31, 1927, was:

Company A	
Preferred stock—6%	$10,000,000
Common stock—920,000 shares (par value $50)	46,000,000
Surplus	17,600,000

Company B	
Preferred stock—6%	$25,000,000
Common stock—230,000 shares (par value $100)	23,000,000
Surplus	4,700,000

No intangible assets were included in the accounts of either company.

The preferred stock of company A was unchanged during the period from 1922 to date: the common stock outstanding was 700,000 shares in 1923, 750,000 in 1924 and 1925, 800,000 in 1926 and 920,000 shares in 1927.

The stock of company B, preferred and common, had not varied since 1922.

The profits were as follows:

	Companies	
	A	B
1923	$5,320,000	$1,760,000
1924	5,780,000	2,340,000
1925	6,400,000	3,100,000
1926	6,700,000	3,750,000
1927	7,900,000	4,080,000

It was proposed that company A should issue additional stock, preferred and common, and offer, for the preferred stock of B, preferred stock of A, share for share; and, for one share of common stock of B, one-half share preferred stock of A and one share of common stock of A.

The market prices, December 31, 1927, were:

	A	B
Preferred	102	98
Common	98	146

Compare the value of one share of B common stock with that of one share of common and one-half share preferred of A on the following bases:

(1) Profits.
(2) Assets at December 31, 1927.
(3) Market quotations.
(4) The indicated trend of profits, taking into consideration the fact that company B had been more recently established and had passed through a period of rapidly increasing profit.

(Disregard goodwill in the solution of this problem.)

No. 3 (15 points):

After the closing of nominal accounts to profit-and-loss account but before the transference of profit and loss to surplus, a company's books show a profit of $200,000 for the year ended December 31, 1928.

In arriving at this profit, the company's bookkeeper has taken into account actual receipts and disbursements during the year with regard to the following items: interest received, $9,000; interest paid, $1,250; local taxes paid, $12,000; insurance paid, $7,000, and cash discount allowed, $12,500.

(a) Prepare a statement adjusting the profit for the year, taking into consideration the following accruals:

	December 31 1927	December 31 1928
Interest receivable accrued....................	$2,500	$3,000
Interest payable accrued......................	200	180
Local taxes prepaid..........................	2,500	3,000
Insurance prepaid...........................	3,250	2,000
Reserve for cash discount on accounts receivable...	3,750	2,500

(b) Give the journal entries prepared to explain your adjustments on the company's books.

No. 4 (10 points):

You are called upon to advise the officers of a large financial organization, whose business involves the investment of increasingly large funds.

They have invested in 6 per cent. first mortgages, and also in bonds (railroad, industrial, etc.) on which the gross yield, at present prices, does not average more than 4.75 to 4.95.

Discuss their problem in a brief report, pointing out factors such as risk of loss, or expense, that would tend to make one class more desirable than another.

No. 5 (20 points):

The Deep Mine Company issued $50,000 worth of four-year, first-mortgage, sinking-fund, 6 per cent. gold bonds dated July 1, 1924.

The bonds were sold on September 1, 1924, (with accrued interest) at $103.59, a price at which they were advertised to yield 5 per cent. (semi-annual coupons).

The bond indenture provided (1) that 25 cents per ton mined would be deposited on June 30th of each year with the Central

Trust Company for sinking-fund purposes and (2) that a sinking-fund reserve would be set aside on a straight-line basis.

The production of coal was as follows:

Year ended June 30, 1925	42,000 tons
" " " " 1926	56,000 "
" " " " 1927	50,000 "
" " " " 1928	58,000 "

The sinking fund earned 4 per cent. the first year and 5 per cent. thereafter.

Submit all journal entries necessary to express all these particulars on the books of the company.

No. 6 (20 points):

X agrees to rent Y's store for ten years at the following annual rentals payable in advance:

First three years	$3,000
Next four years	3,600
Last three years	4,000

If money is worth 5 per cent. compounded annually, what is the value of the lease the day it takes effect?

Submit proof of your answer.

Given—

$V^2 = 1.85941043$; $V^6 = 5.07569206$; $V^9 = 7.10782168$

Examination in Commercial Law

MAY 17, 1929, 9 A. M. TO 12:30 P. M.

Answer only ten questions as directed, and give reasons for all answers.

(Each question counts 10 points)

GROUP I

Answer all the questions in this group.

No. 1.

The X Y Corporation is engaged in the real-estate business. It owns a building, the cost of which was $300,000. In July, 1928, it sells the building for a price which nets it $350,000. It then reinvests the proceeds of the sale in another building. Other than the profit on the sale it has only sufficient income to pay its operating expenses. Can the directors declare a dividend to the stockholders and, if so, by what means?

No. 2.

Royce becomes the holder of a negotiable promissory note in regular form made by A to B and bearing several full endorsements. He endorses the note to Church for value, but "without recourse." When Church endeavors to collect upon maturity of the note, it is discovered that A is an infant and refuses to pay. Church then sues the endorsers, including Royce. Has Royce any defense?

No. 3.

A company enters into a contract with Y agreeing to manufacture and deliver to him, at an agreed price, 5,000 ladies' sweaters, deliveries to be made in equal quantities over a five-months' period. Before any deliveries can be made the company's employees go out on a strike which remains unsettled for a period of two or three months beyond the last delivery date. Y is compelled to buy his sweaters in the open market and brings suit to recover damages for the failure of the company to carry out its contract. Can he recover? If so, could the company have protected itself in the contract against such a liability?

No. 4.

You are the owner of 500 shares of common stock of the Z Company. In 1928 it issued to its stockholders rights to subscribe for further stock at a specific price, one right for each share of stock held. You do not exercise your right to subscribe but you do sell the rights on the market. Under the 1928 federal income-tax law, how should the sale of the rights be treated on the tax return?

No. 5.

"$500. January 1, 1928

"For value received I hereby agree to pay to A. C. Goodwin or order the sum of five hundred dollars ($500) in five instalments of one hundred dollars each, on the first day of each of the next following months of February, March, April, May and June, with interest on all unpaid principal at the rate of 6 per cent. per annum payable with each instalment, and in the event of any default in the payment of any instalment or interest, the whole balance of said principal sum and interest shall be and become immediately due and payable. All payments to be made at First National Bank.

"(Signed) John Smith."

Is this a negotiable promissory note?

GROUP II

Answer any five of the following questions, but no more than five:

No. 6.

You are in the employ of Jones & Co., a co-partnership engaged in the stock-brokerage business. Your employers offer to compensate you for your services by a share in the profits of the business. An agreement is submitted to you to carry out the offer. Before you sign the agreement, and for your protection, what, if any, provisions should you insist upon including in the agreement other than those relating to your sharing in the profits?

No. 7.

The X Y Corporation has outstanding $250,000 in 6 per cent. non-cumulative preferred stock and 2,500 shares of no-par-value common stock. During each of the years 1926, 1927 and 1928, the corporation made net profits of $25,000. No dividends were declared in 1926 or 1927, the directors allowing the profits to remain in surplus. Late in 1928, the directors declared a dividend of 6 per cent. on the non-cumulative preferred stock and $23 per share on the no-par-value common stock. The preferred stockholders objected to the dividend on the common stock, claiming that they were entitled to receive 18 per cent. of the then existing surplus before any of it could be available for common-stock dividends. Was the objection valid?

No. 8.

B, a violin expert, ascertained that A owned an old violin of famous make, worth many thousands of dollars. In talking with A, B found that the violin had been in A's family for many years, but that A had no knowledge of its true value. B, after some persuasion and by offering what to A seemed an excessive price ($350), succeeded in buying the instrument. Later A heard of the true facts and, tendering a return of the purchase price, sued to recover the violin. What, in your opinion, would be the result?

No. 9.

Explain the difference between personal defenses and absolute defenses in an action on a negotiable instrument, and name some instances of each kind.

No. 10.

Goods shipped to you by railroad, while in the railroad's warehouse awaiting delivery to you, are destroyed by a fire which

is not due to any negligence on the part of the railroad. What are the important facts to be determined in order to establish upon whom the loss falls?

No. 11.

On March 1, 1913, the A Company had an earned surplus of $500,000. Between that date and January 1, 1928, it added $1,000,000 to the earned surplus. On January 5, 1928, the directors adopted resolutions declaring two cash dividends, one of $500,000 declared as payable out of surplus earned prior to March 1, 1913, and one of $500,000 declared as payable out of the later accumulated surplus. A stockholder claims that the first dividend is not taxable for surtax under the federal income-tax law, because it is paid out of earnings made prior to March 1, 1913. The examining agent for the internal-revenue bureau disputes this, claiming that the directors had no power, so far as the income-tax law is concerned, so to allocate the dividend payments. Who is correct?

No. 12.

What is a statute of limitations and what is its object?

No. 13.

Explain what is meant by each of the following: act of bankruptcy, voluntary bankruptcy, involuntary bankruptcy, composition.

No. 14.

Give an example of a contract on which, in the event of a breach, specific performance would be granted by the courts.

Examination in Accounting Theory and Practice

PART II

MAY 17, 1929, 1 P. M. TO 6 P. M.

The candidate must answer all the following questions:

No. 1 (35 points):

On behalf of the First National Bank, you have been instructed to make an examination relative to the balance-sheet and statements of income and expense submitted by the X Jobbing Company. It appears that the bank is suspicious of the inventory valuation as shown on the balance-sheet of April 30, 1929.

As set forth in the statements presented, the inventory value of April 30, 1929, has been computed by the gross-profit method to avoid the taking of a complete physical inventory at that date. There is even some question as to the authenticity of the inventory value of December 31, 1928, as reflected in the income-and-expense statement, but there is no doubt as to the accuracy of the previous inventory, inasmuch as that was taken under your personal supervision at the time of your audit for the year ended December 31, 1927.

At the outset of this examination, you decide to make several test checks with respect to the figures of 1928 since no audit was made subsequent to December 31, 1927. You observe that the rate of gross profit reflected by the income-and-expense statement submitted for the year 1928 is unusually large as compared with the 1927 audit report and, by reference to the commodity cost records maintained by the sales department for purposes of arranging commissions to salesmen, you observe that there has been a uniform mark-up on the goods purchased of approximately 25 per cent. on cost during each month of 1928 and up to April 30, 1929, and that in the recorded cost figures the invoice prices have been adjusted by freight paid and discount on purchases.

After a complete examination of the physical inventory sheets, warehouse stock records, etc., you disclose the fraudulent overstatement of the physical inventory of December 31, 1928, the actual inventory value at that date being $276,202.

An analysis of the freight account for the year 1928, reveals the following:

Freight on purchases	$19,106
Freight outward	3,017

In verifying purchases, you find invoices entered in the purchase record during January, 1929, which are dated December, 1928, and the receiving tickets show that the merchandise was received during 1928 to the extent of $3,062. In discussing this matter with the warehouse foreman, you ascertain that this merchandise was included in the actual physical inventory taken.

After satisfying yourself that no other irregularities exist, you are to prepare corrected statements as follows:

Income-and-expense statement for the year ended December 31, 1928.

Inventory computation as at April 30, 1929.

Income-and-expense statement for the four months ended April 30, 1929.

Reconciliation of surplus as shown on corrected balance-sheet and original balance-sheet—April 30, 1929.

X JOBBING COMPANY

Balance-sheet, April 30, 1929

Assets

Current:			
Cash in bank and on hand		$ 21,679	
Accounts receivable	$110,873		
Less: allowance for doubtful accounts	15,000	95,873	
Merchandise inventory (computed)		369,539	$487,091
Permanent:			
Equipment		$ 23,916	
Less: allowance for depreciation		7,422	16,494
Deferred			2,302
Goodwill			100,000
			$605,887

Liabilities and Capital

Current:			
Notes payable—bank		$225,000	
Accounts payable		53,093	
Accruals		4,918	
Reserve for federal income tax, 1929—estimated		2,637	$285,648
Capital stock:			
Preferred outstanding		$100,000	
Common outstanding		125,000	
Surplus:			
Balance—January 1, 1929	$ 75,902		
Profit for period to April 30, 1929	19,337	95,239	320,239
			$605,887

Inventory computation, April 30, 1929

Inventory—December 31, 1928			$318,198
Add:			
Purchases		$227,183	
Freight on purchases		6,213	233,396
			$551,594
Deduct:			
Cost of goods sold (computed):			
Sales	$260,128		
Less: discounts and allowances	4,792	$255,336	
Less: gross profit (28.70%)		73,281	
Cost of goods sold (as computed)			182,055
Inventory—April 30, 1929 (as computed)			$369,539

Income and expense for the year ended December 31, 1928

Sales		$762,107	
Less: discounts and allowances		12,792	
Net sales			$749,315
Cost of goods sold:			
Inventory—January 1, 1928		$168,472	
Purchases	$690,122		
Less: discount on purchases	6,129	683,993	
		$852,465	
Inventory—December 31, 1928		318,198	
Total cost of goods sold			534,267
Gross profit (28.70%)			$215,048
Selling and administrative expenses:			
Officers' salaries		$ 30,000	
Salesmen's commissions		44,129	
Freight—inward and outward		22,123	
Bad debts written off		9,492	
Depreciation—equipment		2,392	
Other expenses (summarized)		50,629	158,765
Operating profit			$ 56,283
Other income:			
Interest earned		$ 223	
Profit on sale of capital assets		619	842
			$ 57,125
Other deductions:			
Interest paid			10,630
			$ 46,495
Provision for federal income tax (12%)			5,579
Net profit to surplus			$ 40,916

Income and expense for the four months ended April 30, 1929

Net sales (see schedule)		$255,336
Cost of goods sold (see schedule)		182,055
Gross profit		$ 73,281
Selling and administrative expenses:		
Officers' salaries	$ 10,000	
Salesmen's commissions	13,791	
Freight outward	4,978	
Bad debts written off	3,623	
Depreciation—equipment	793	
Other expenses (summarized)	17,360	50,545
Operating profit		$ 22,736
Other income:		
Interest earned	$ 103	
Cash discount on purchases	3,297	3,400
		$ 26,136

Other deductions:	
Interest paid	$ 4,162
	$ 21,974
Provision for federal income tax (estimated).	2,637
Net profit to surplus	$ 19,337

No. 2 (15 points):

The balance-sheet of Broad and Wall, a partnership, as at December 31, 1927, was as follows:

Assets

Cash	$ 10,000
Accounts receivable	90,000
Inventory	60,000
Fixed assets	50,000
	$210,000

Liabilities

Notes payable	$ 20,000
Accounts payable	30,000
Capital:	
Broad	100,000
Wall	60,000
	$210,000

Profits were shared in the following proportions: Broad, three-fifths; Wall, two-fifths.

On payment of $75,000, Roe was admitted to partnership with a one-fifth interest in the capital and profits of the new firm of Broad, Wall and Roe, whose total capital on Roe's admission, December 31, 1927, was agreed upon as $250,000.

The profit for the half year ended June 30, 1928, amounted to $40,000.

During the half year, the partners' withdrawals were: Broad, $14,000; Wall, $10,000, and Roe, $6,000.

Prepare (a) the journal entries recording the transactions on Roe's admission to partnership and (b) statements of the individual partners' accounts at June 30, 1928, after crediting the respective proportions of profit.

No. 3 (20 points):

A testator leaves $1,000,000 invested in securities yielding five per cent. per annum and other property, specifically bequeathed, valued at $500,000.

Preferred pecuniary legacies to be paid by the executors amount to $50,000. Provision is made for four annuities of $500 each for five years, two annuities of $1,000 each for five years and two annuities of $1,000 each for ten years, and the executors are to receive five per cent. of all bequests distributed by them. Federal and state estate taxes on the whole estate, and state inheritance taxes on preferred legacies to be distributed by the executors and those on all annuities amount to $60,000.

At the end of two years, during which interest received on securities aggregated $96,000 and legal, accounting, clerical expenses, etc., amounted to $20,000, the executors transferred the balance of the estate to trustees who were entitled to receive $10,000 per annum as salaries and three per cent. commission on all bequests distributed by them. They received, further, $2,000 per annum for expenses.

The terms of the will instructed the trustees to continue the trust until twelve years after the testator's death, or five years longer if necessary, to pay a special legacy of $100,000 (inheritance tax to be paid by legatee) five years after the testator's death and finally to distribute certain deferred legacies aggregating $1,000,000, pay a seven per cent. inheritance tax thereon and hand the balance to the residuary legatee who would pay his own inheritance tax.

With the purpose of ascertaining whether or not the terms of the will, as specified, are workable, you are required to prepare statements showing (a) the amount paid to the trustees by the executors and (b) the amount paid to the residuary legatee by the trustees with the date of such payment, i. e., the number of years after testator's death.

Assume that funds can be invested to yield five per cent. per annum and use simple interest only in each step of your computations.

No distinction need be made between principal and income in either executors' or trustees' accounts.

No. 4 (20 points):

From the trial balance following and accompanying data, prepare the balance-sheet of the X Y Z Company as at December 31, 1928.

Trial balance—December 31, 1928

	Dr.	Cr.
Cash in banks	$ 40,000	
Petty-cash funds	500	
Notes receivable	11,000	
Accounts receivable	75,000	
Treasury notes	65,000	
Loans on call	100,000	
Investment—A B C Company	25,000	
Inventories	80,000	
Land and building	75,000	
Machinery	125,000	
Office furniture	5,000	
Goodwill	50,000	
Accounts payable		$ 85,500
Notes payable		50,000
Capital stock—first preferred		200,000
Capital stock—common		200,000
Surplus		75,000
Reserve for doubtful accounts		1,000
Reserve for depreciation—building		5,000
Reserve for depreciation—machinery		30,000
Reserve for depreciation—office furniture		5,000
	$651,500	$651,500

(1) Notes receivable discounted aggregate $30,000.

(2) Accounts-receivable account is made up as follows:

Trade accounts—debit balances $66,000, credit balances, $1,700.

Advances to A B C Company in 1910, $10,000.

Advances to officers (collected since December 31, 1928), $500.

Claims (collected since December 31, 1928), $200.

(3) Trade accounts regarded as doubtful of collection, $800.

(4) Treasury notes are pledged to secure notes payable.

(5) Call loans represent temporary investment of funds accumulated to acquire new plant.

(6) Investment—A B C Company (100 shares of $100 each) is at cost; market value, December 31, 1928, $45,000.

(7) Cost of land, $25,000; building, $50,000.

(8) Machinery—chiefly manufactured by company and set up at estimated cost.

(9) Accounts-payable account includes a debit balance of $2,000, representing advance payment on merchandise.

(10) Capital stock:

First preferred—7% cumulative, authorized $300,000, par value $100 per share.

Common—authorized $400,000, par value $100 per share.

(11) Federal income tax for the year 1928, $25,000.
(12) Dividends declared in December, 1928, payable January 3, 1929:
First preferred stock, $3,500.
Common stock, $2,000.

No. 5 (10 points):

From the following balance-sheets of companies A and B prepare a consolidated balance-sheet, using the figures here presented which appear on the books of the respective companies.

Criticize or make recommendations for the correction of the resulting statement, if you think any are required, bearing in mind that for purposes of local taxation, company B's books must show correct results for that company as a unit.

Company A owns 100 per cent. of the stock of company B.

COMPANY A

Buildings and machinery	$700,000	
Less: Reserve for depreciation	200,000	$500,000
Investment in Company B		100,000
Current assets		150,000
Advances to company B		25,000
		$775,000
Capital stock—5,000 shares (par value $100)		$500,000
Current liabilities		50,000
Surplus—free	$200,000	
Appropriated for advances to company B	25,000	225,000
		$775,000

COMPANY B

Land		$ 10,000
Buildings (at cost)	$115,000	
Less: Reserve for depreciation	15,000	100,000
Additions to buildings	$ 25,000	
Less: Reserve for depreciation	5,000	
		20,000
Current assets		10,000
		$140,000
Capital stock		$100,000
Loan from company A		25,000
Current liabilities		5,000
Surplus		10,000
		$140,000

Benevolent Organizations and Their Accountability to Their Supporters*

By Charles E. Mather

The public duty to look after those in need is becoming more and more widely recognized, whether the need be for food or shelter, protection from floods, education (religious or secular), hospital attention or support in decrepitude due to old age or in disability due to accident or disease. There are also innumerable objects some of us should like to see accomplished, and organizations aiming to do so by coöperation appeal to us for help.

There is necessarily, and probably always will be, a large margin between the public provision and actual need, which must be met, if met at all, by private benevolence. As we advance in standards, needs are recognized which were not thought to exist before, and kind-hearted people are coming forward to meet this or that newly recognized need. At first they may gather a few friends of the same way of thinking and start a good piece of philanthropic work. Then they realize the field is much wider than they expected; their own means, however large, have limits, so they seek to interest a larger public in the enterprise. But how to do it? Their time is more limited than their means. They themselves experience a need; the need of someone who knows how. This is the chance for the expert, and he has not been slow to see the chance. And here, as in every sphere, the need seems to create the supply, and then the supply outgrows the need and creates more need. The door is open wide for the professional money-raiser.

Without implying anything improper in the conduct of appeals, drives, campaigns and the like, this is at least certain, that we are all deluged with requests either to buy goods we do not want, or to contribute to some worthy object, and the latter appeal is often couched in such touching terms that we feel guilty of neglect of duty if we refuse.

These campaigns involve enormous expense. If it is to push the sale of goods, we don't worry; we need not buy if they are not worth the price. But if it is an appeal for a benevolent object, especially one in which we are already interested, we wonder how

* Address delivered at a meeting of the New York State Society of Certified Public Accountants.

much of our money went or will go to the real work we desire to help, and how much for printing, postage, office force, or campaign manager's honorarium or commission. This we feel entitled to know.

In brief, just as we are entitled to value for our money in ordinary trade, so in case of voluntary contributions we are entitled at least to knowledge of the following:

1. That a report, however concise, is submitted to all contributors at least annually.
2. That there is some independent, disinterested inspection, control or audit made regularly, at least annually.
3. That the management is in the hands of experienced, judicious and responsible persons and that the officers and committee actually exercise proper oversight.
4. That no undue proportion of the total funds is spent on the cost of making appeals, collecting money, office management and other overhead charges.
5. That the money we contribute actually reaches the coffers of the organization and is devoted to its legitimate purposes.

Taking these in order, we may imagine that the first item, the report, if competently prepared, should satisfactorily cover all the other points. With the exception of the last, it may very well do so. To this end, it should summarize the work done, and give a statement of income and expenditure, over a certificate of a reputable public accountant or firm of accountants, which covers the second point. This cash statement should show how much has been spent and how it has been spent. There should also be a list of directors and managers, among whom contributors will look for the name of either a personal acquaintance or at least a person of some standing or wide repute in the business world or some sphere of public activity. In a measure this deals with the third point. The fourth question, as to amount of overhead, should be answered by the cash statement: but in practice it will be very difficult to determine what is overhead. Frequently, the analysis is not designed to show this, and the impression given may be too favorable or too unfavorable to the organization. Salaries, for instance, may be either for services devoted to the accomplishment of the object, or for the services, equally necessary, of organizing and managing and office routine. Even if these salaries and all other expenses are properly classified, and indication is given as to whether they represent benevolence or

management, most contributors will be poor judges as to the reasonableness of the ratio between the two. These questions as to what is reasonable cost of management can often be settled by applying to one or another of several organizations that exist especially to collect and make available information concerning management and operation of institutions or causes soliciting support from the public. It can not be expected that published accounts will disclose very much detail on this point.

With regard to keeping down the overhead expense of collection and at the same time giving confidence, a paragraph like this at the foot of each appeal might be effective:

> "It is requested that all contributions be made by cheque payable to the organization (giving name). The endorsed cheque will then serve as a receipt and no further acknowledgment will be given unless requested. The thanks of the management are hereby expressed."

We are perhaps disposed to be rather unreasonable in our criticism of the amount of overhead in an organization for benevolent purposes. We are aware of the heavy overhead charges in manufacturing and especially in merchandising under present-day conditions, and we can hardly expect that benevolent work can be carried on for nothing. The result of a recent appeal on a large scale was brought to my notice in the form of a souvenir booklet issued by the firm that engineered the campaign. It was claimed as a great achievement that a sum exceeding $20,000,000 had been raised at a cost of less than 2½ per cent. of the money raised. This seemed a very reasonable percentage; but even a superficial scrutiny showed that 2½ per cent. amounted to $500,000; that if the cost were equally pro-rated over every gift, even at 2½ per cent., some gifts must have cost $25,000 each to collect; or that, spread over the total number of donors, each gift cost, on an average, nearly $25. Looked at in that way, the cost seems extremely high; but in this particular instance all criticism was disarmed by a statement that the entire costs of the campaign were privately defrayed by one or more individuals.

In fact, if the organizers or directors making any appeal are themselves deeply interested, they may be willing even to contribute enough to cover all overhead expenses or all but a limited proportion, and thereby satisfy the public that its money is entirely devoted to the direct purposes of the benevolence.

But, assuming everything to be satisfactory so far, the last point and the main point of these remarks is not covered. How do we

know that our individual gifts were actually devoted to and formed part of the cash income for which the statement accounts? "Why, of course it did," thinks one, "I handed it myself to my friend John Doe." Or "I paid it by cheque, made out, as requested, to the treasurer, Richard Roe", who is a man above suspicion. "Well," replies another, "the accounts are audited, are they not? What's the use of an audit if it does not see that my subscription was received?" Or again "I hold a printed receipt, signed by the treasurer, or, on further inspection, I see it is by someone signing for the treasurer—no doubt that is what these initials mean; it must be his secretary; at least he is responsible; it is all right, I am sure."

Many things of which we are sure are simply not so. This may very well be one of them. But in defense of the auditor let it be fully recognized, as philosophers of old maintained, that it is impossible to prove a negative. Modern optimists say the difference between the difficult and the impossible is that the latter takes longer. It is so much longer in the matter under discussion that we may say it is so difficult as to be impracticable. What does the auditor certify? Sometimes we do not know: we are merely informed on the authority of the management that "the accounts have been audited by ——." But if the certificate is printed we find that the auditor either goes into some detail and says exactly what he has done, or merely says "audited and found correct" or "compared with the books and vouchers and found to be in agreement therewith" or, in some instances, a more lengthy statement, indicating considerable time, thought and trouble—often, let it be remembered, for no fee; almost always for inadequate compensation. Very rarely is there any reference to subscribers or contributors or members, or whatever the friends are called who send in money. A schedule of thirteen certificates taken at random (page 426) shows a great variety in method of stating results and scope of work done.

While recognizing and admitting the value of an audit in all cases, it is a fact perhaps not fully appreciated by accountants that the contributing public often places an exaggerated value on the protection afforded by such an audit. It is of very little consequence to the contributor how the certificate reads, so long as the signatory is a reputable accountant or firm whose name is well known. I recall a case in my own experience many years ago where an organization was carried on to afford an outlet for art

work done by women of good families but very limited means. Articles made by them were turned in to headquarters where they were sold on a small commission. This commission did not nearly cover the overhead, the balance being made up by voluntary contributions. The accounts, but only the accounts, were audited annually either gratuitously or for a merely nominal fee. After a number of years members were complaining that they had not been paid for their goods and investigation disclosed that the goods which were not paid for were missing and had either been stolen or sold and the proceeds misappropriated. Were the auditors responsible for this? Obviously the audit did not include and could not have included the entire check of the inventory of goods on the shelves in order to see that everything had been paid for unless still on hand. And yet the auditors were regarded as morally delinquent by the management committee which ultimately made good the deficiency. This serves to show that the auditor when he certifies is popularly believed to certify the correctness of everything.

But suppose the most modern system is adopted, and the auditor examines and checks all the stubs or carbons of receipts, goes carefully through the card systems and follow-up system—what does he finally accomplish? He has found support for each and every item appearing in the books, and seen that all they represent went into the bank. Good! But he still has not proved the negative. He has not proved that there are not some contributions, including your own, which have been omitted entirely from the bank, the cashbooks, the stub books, carbons, cards and the whole system.

The only way for you to prove that your subscription is accounted for is (a) to see to it yourself that it is entered in the cash account or (b) to see that your representative, the auditor, has seen it and that it appears in a detailed list, which is referred to specifically in the audit certificate as including all contributions accounted for by the treasurer. The first is impracticable; the second is rarely done, and is only practicable when the full list is printed and published in the annual report. Even then it is not always made clear by the auditor—indeed it is very rarely evident—that he has satisfied himself that the total of the list is accounted for in the cash statement.

A recent report of a most worthy cause of wide appeal, with irreproachable management, audited by a firm of accountants of

the highest standing, contained a list of contributions which differed by several thousands of dollars from the amount in the cash statement. The explanation, clear when the dates were compared, was that the list was made up to one date and the treasurer's statement to another.

Printing and circulating a full list, unless it is linked up by the auditor with the statement of accounts, fails of its purpose. Furthermore, it is open to the two objections of (a) expense and (b) undesirable publicity. In a large organization the expense is not a heavy item in proportion to the whole annual expenditure and in many cases is entirely desirable. The publicity is objected to on the grounds that it exposes the donor to attack in new campaigns. If so, he can hide behind a code name. But that is futile. He is already on every mailing list, so the objection is groundless.

It may possibly be objected, in criticism of these remarks, (1) that there is very little dishonesty among the employees of such organizations and (2) that any remedy which might be suggested is futile. To these objections can be offered the analogy of the cash register, the use of which is now almost universal. If honesty were absolutely universal the cash register would supply no want. It is to avoid the temptation to dishonesty that a cash register is used in almost all retail businesses. The amount of a purchase once rung up on the cash register enters into the machine record of the day's total, and it is then possible for the proprietor or his trusted representative to see that the total amount of purchases is duly deposited.

The value of the cash register as a check on the sales force lies in the opportunity given the purchaser to check for himself the amount recorded. How many times does he do this? No one knows—perhaps once in a hundred times, but, however frequent or infrequent it is, nevertheless it is believed to act as a deterrent and the salesman never knows who is going to look and who might report a failure to ring up the full amount. There is no justification for assuming a higher degree of honesty among those working for voluntary organizations than among those engaged in retail business. As to the sum involved, THE JOURNAL OF ACCOUNTANCY in a recent article described the accounting system of one single organization that had handled over $80,000,000. A weekly magazine recently stated that the annual sum voluntarily given to benevolent objects has exceeded two billion dollars, and is growing.

Application of this analogy points to the remedy in case of voluntary contributions. It is that a complete alphabetical list of all contributions received within the fiscal year be submitted to the auditor to be signed by him for identification after he has verified the total and compared it with the total contributions accounted for in the report, such list to be filed by the auditor with some independent public body, such as the chamber of commerce, the office of the community chest, a bureau of advice and information, or whatever may be suitable in the locality; and that the list be open for inspection by any contributor or his representative at proper times and within proper limits. A duplicate, also signed, should be on file in the office of the organization.

The foregoing does not imply that there is any widespread dishonesty among those handling charitable funds, nor that the overhead is needlessly heavy. The management expense in many cases is heavy enough to afford comfort to the conscience of the selfish and self-centered man of wealth who gives little or nothing and excuses himself on the ground that money so given is largely wasted. And if any dishonesty exists at all—as we know it does in business conducted for profit, where the owners can well afford, in their own interests, to take every precaution—there is justification for the simple and inexpensive precaution outlined above. It is more than justified; it is an imperative obligation to the contributing public.

This is not the place to give interesting details of how fraud and embezzlement may easily be perpetrated. It is sufficient to say that it is easy, to one who knows how, when so many loopholes exist and when it is nobody's business to check up on the small and multitudinous items of which voluntary income consists.

It is an old proverb that opportunity makes the thief. It is therefore the duty of the contributing public to see that no needless opportunity is given. The following simple precautions may be observed by any contributor:

1. Never give cash—always pay by cheque.
2. Never make your cheque payable to the treasurer or to any individual, but always to the organization.
3. Always examine the endorsement on your cheque, as the official receipt guarantees nothing.
4. Look for your name in the annual report and see that an auditor's certificate connects the list with the cash statement.

5. If no list is printed, ascertain that one exists and that it is readily available for your inspection should you desire to see it, and then inspect it occasionally.

The suggestion as to cheques is made quite irrespective of the reputation and standing of the many honorable gentlemen (and ladies) acting as treasurers; not only do they seldom handle the cash remittances themselves, but even with the best intentions mistakes occur. Frequently a prominent citizen is treasurer for many organizations, and gifts have been known to go to a cause for which they were never intended, because they were payable to the treasurer and not to the selected organization.

After collection and analysis of a considerable number of certificates by individuals and by firms of high standing both in this country and in England, only a few of them have been found to contain any reference to the point here emphasized. If the point has been covered in the other cases, at least it has not been mentioned in the certificate. Following is a list of actual certificates of statements of benevolent organizations:

1. "Audited by . . ."
2. "Audited and found correct."
3. "The foregoing figures are extracts from the certified report of . . . "
4. "This is to certify that we have examined the accounts of . . . and find them to be correct in every respect."
5. "Pursuant to your request we have audited the books and vouchers of the . . . for the calendar year . . ., have verified the cash, and
   "We hereby certify that the accompanying statements showing the Income and Expenses for the year as at December 31, . . . , are correct, and are in agreement with the books."
6. "We have audited the books, vouchers and other records of . . . for the year . . . , have verified the cash, bonds, stocks, and mortgages owned; and
   "We hereby certify that the accompanying statements showing . . . and the income and expenses for . . . are correct and that the books are in agreement therewith."
7. "We have audited the accounts of . . . as at . . . and we certify that, in our opinion, the above statement of assets and liabilities sets forth correctly the financial position at that date.
   "We further certify that the accompanying statement of cash receipts, aggregating $ . . . , and disbursements, aggregating $ . . . , correctly summarizes the cash transactions applicable to the . . . for . . . "
8. "We have audited the accounts of . . . and we hereby certify that the foregoing condensed statement of cash receipts and disbursements correctly summarizes the recorded cash transactions for . . . "
9. "We have audited and examined the books and the accounts of the Scottish branch of the British . . . Relief Fund, and beg to report that the same are sufficiently vouched and instructed and that we have received all information and explanations which we have required. We certify that the foregoing account is a correct abstract of the transactions with the funds as recorded in the books."
10. "We have audited the books and accounts of . . . for the year ended . . . and certify that table 1 on pages 46 and 47 correctly sets forth the income and expenditures of the hospital and that table 2 on page

48 accurately states the financial condition of the corporation at the close of business December 31, 1927."

11. "We have examined the accounts of . . . for . . .; all receipts as shown by the cashbook and by duplicate copies of consecutively numbered receipts to contributors were traced to the bank, and disbursements were verified by examination of approved vouchers and paid cheques.

"We hereby certify that, in our opinion, the above summary of income and expenses sets forth correctly the results of operation for the year."

12. "Auditor's statement regarding the list of contributions, 1927.

"A complete list of contributions, received during the year 1927, has been compiled as usual. This list we have examined with the books and vouchers of the mission, and found correct." (Signature)

"The list referred to above is open to the inspection of the subscribers at the offices of the mission." (Signed) Superintendent.

13. "We have examined the books and accounts of . . . ; also the separate records of the funds for the year ended. . . . We have compared the record of the cash receipts with the list as published for the year, and have also examined vouchers and canceled cheques evidencing all disbursements, and

"We hereby certify, that the foregoing statements of receipts and disbursements are in accordance with the records which, in our opinion, fully and correctly set forth the financial operations of . . . for . . ."

As a basis for consideration the middle paragraph in the following model certificate may serve with a view to its embodiment, or words to the same effect, in all certificates where voluntary contributions are involved:

I have audited the books and accounts of AB, the treasurer of the CD society, and compared the foregoing statements therewith.

I have personally filed with the B of C the treasurer's list of contributions received between May 1, 1928, and April 30, 1929, and verified the total to be $........, as accounted for in the foregoing statements.

All disbursements have been made on proper authority of the finance committee and are supported by vouchers on file.

If a balance-sheet or statement of assets and liabilities is published reference in the certificate will naturally cover this also in appropriate terms.

The lack of uniformity and the inadequacy of many certificates shows that this subject has received less attention from accountants than it deserves, possibly because it affords little or no opportunity for profit. But the accounting profession can prosper only in so far as it serves the community. And here is an excellent field for service.

Let it be clearly understood in this discussion that no criticism is intended of the manner in which accounts have been and are kept, nor of the excellent work done by public accountants who have audited them. Their work has been limited by the cir-

cumstances as they exist. It has been done mostly gratuitously, or at nominal cost. There has been no public sentiment or conception of what was required, except the desirability of attaching a name of honor and good repute to the accounts.

But out of these very circumstances can we not create a sentiment, a conscience, a standard which should be maintained as a minimum? Should we not be willing, each of us, to take his share of gratuitous or non-profit work along with the rest? If so, then as part of the consideration we can demand that certain things be done in our way. We can insist on the preparation of the list of voluntary contributions, the total of which we can verify and check with the summary of cash received: we can see this list is made available to anyone who, by having contributed, has a right to see it.

And here let a word be said for the natural business year. Those of us who are willing to accept some of this burden can not be expected to do so in the rush of the busy season. There is no need for us to do so. We can serve the organization and ourselves as well by stipulating that, if we do the work, it be at a time convenient to us, and it will be found also to be the best time for the officers of the organization. The rational year-end for most benevolent institutions is probably April 30th, when the winter is well over, and for those carrying on a summer work perhaps October 31st.

Whatever institution or bureau may be found to act as depositary for annual reports and lists may well keep also a list of accountants willing and public-spirited enough to undertake work on the terms and conditions indicated.

In conclusion, the chief points on which the influence of accountants can be brought to bear are:

1. Auditor's certificate, more uniform and explicit.
2. A complete list of contributions publicly filed, available to all donors, whether it be printed and circulated or not.
3. Greater use of a central bureau for the information of contributors.

Perhaps in time the trustees of our institutions will regard accountants' certificates as vitally necessary to their treasurers' statements. In time the contributors may become accustomed to look for and demand them. Then we shall have performed a valuable service to our community.

Some Legal Aspects of Goodwill

By L. L. Briggs

The existence of goodwill is generally shown by profits above normal for the business under consideration. The continuance of these super-profits over a period of years is an essential indication of goodwill, so a new and untried concern can lay no valid claim to the possession of this form of property. There is, however, some conflict among court decisions on the necessity of profits for the presence of goodwill. In the case of *MacFadden* v. *Jenkins*, 40 N. D. 422 (1918), the court maintained that there may be goodwill in a business even though there have been no profits. The judge gave as an example a mortgage company which made loans to farmers at rates lower than those which were prevalent and profitable. This concern had the goodwill of its patrons, but still it lost money. Apparently Justice Grace considered that goodwill was merely a kindly feeling of the customer toward the business which he patronized and that profits were not concerned. This is not the general legal conception of goodwill. In *Halverson* v. *Walker*, 38 Utah 264 (1910), the court insisted that if the business were such that when properly managed it would not yield sufficient to pay debts it was not a desirable business and the goodwill thereof might not be considered as of any value to a prospective purchaser. There is another well known decision to the same effect. Most jurists accept this view.

That goodwill is property has been settled by a long line of decisions in both the English and the American courts. Circuit Judge LaCombe said: "That it is property is well established by authority." North Dakota has a section in its statutes stating: "The goodwill of a business is property." An Indiana court has qualified the general statement by saying that the goodwill of a business is not of itself property, but is only an incident that may attach to or be connected with property. The point involved in the case was whether or not the goodwill of a newspaper was property according to the constitution of that state. The court ruled that it was not property by itself. This in reality does not change the generally accepted idea because goodwill is understood to be an incident of other property.

The law protects goodwill to the same extent that tangible property is protected. Nearly half a century ago, Justice Clap-

ton said: "It is regarded as an appreciable and important interest which the law will protect." If goodwill is unlawfully destroyed or taken from the owner, the courts will award damages to the injured party. Justice Trimble, when rendering a decision concerning this phase of goodwill, said: " . . . the law will . . . award damages for injuries thereto." If a buyer is induced by fraud to purchase goodwill, he is entitled to damages from the seller. Even though there may be no statute covering this type of case, the precedents in the common law will govern. Goodwill is protected both by statute law and by common law in England, but in America, with a few exceptions, common law seems to be sufficient to give justice to the parties involved in goodwill litigation.

Numerous decisions have been rendered to the effect that goodwill is an asset. The English cases date from 1856, when Sir John Romilly, master of the rolls, said: "The goodwill of a trade, although inseparable from the business, is an appreciable part of the assets of a concern, both in fact and in estimation of a court of equity." Many American decisions follow the same line of thought. Of these the following words of Justice Spring are characteristic: "The element known as goodwill is held by the courts to be an asset in estimating the value of the property." Justice Brown of the United States supreme court has maintained that goodwill is a legitimate asset where it is actually existent. However, it is not an available asset in the sense that it can be turned into money by itself because it has no salable value apart from the tangible property with which it is connected. The courts have allowed it to be counted as an asset to decide whether or not a business was solvent. An exception occurred in the case of an insolvent insurance company, in which Justice Sheldon expressed his opinion as follows: "The goodwill of the company would be a poor species of assets to pay losses with, and it is funds that will pay losses that an insurance company is required to have by law." Generally, the goodwill of a decedent's business is considered a part of the assets of his estate. Several American rulings are to this effect. If the decedent's property is sold, the proceeds of the goodwill are divided as is the rest of the property. There is one notable exception to the general rule that goodwill is an asset. The court, in the case of *Seighman* v. *Marshall*, 17 Md. 550 (1861), ruled that the goodwill of a printing office was not an asset under the statutes of Maryland because the value was too uncertain and

contingent to be the subject of estimate. The majority opinion is that goodwill is an asset to the individual enterprise, to the partnership and to the business corporation.

Intangibility is generally a characteristic of goodwill. In a leading English decision, Sir John Romilly said: ". . . the goodwill . . . is never tangible unless it is connected with the business itself, from which it can not be separated, and I never knew a case in which it has been so treated." Chief Justice Fuller, speaking of the same subject, said: "It is tangible only as an incident, as connected with a going concern or business having a locality or name . . ." Several other jurists have taken the same position. There is at least one decision that does not concur. Judge Humphries gave his opinion in these words: "We think the goodwill of a business is a tangible thing." The learned justice seems to have a concept of goodwill which is different from that held by most jurists, because he made this statement: "We see no difference between the goodwill of a business and any other valuable asset possessed by it."

The consensus of opinion among judges is that goodwill can not exist independently but always must be connected with and rest upon some principal and tangible thing. It has no meaning except when applied to a continuing business, and to the property of such a going concern it is an incident. It is not separable from and generally can not be sold independently from the other assets. There are some exceptions which will be discussed later, but this has been the attitude of the majority of the jurists who have had the duty of making decisions involving this phase of goodwill. Justice Weaver gave an excellent statement of the legal view when he said: "Ordinarily, though perhaps not universally, goodwill is a thing having no existence except as it attaches to the tangible."

There is some variation among the statutes of the states in respect to the taxation of goodwill. As far as the common law is concerned, goodwill is taxable like any other form of property. The attitude of the courts was well expressed by Justice Cobb when he said: "Goodwill . . . may be taxed like any other form of property, if its value can be ascertained." The last clause suggests an obstacle which might cause the tax authorities some trouble. In New York it has been ruled that the transfer of goodwill is taxable under the law relating to taxable transfers. The courts of the same state handed down a decision to the effect

that the goodwill of a foreign corporation engaged in business within that state was taxable as property employed therein. This seems unjust to the foreign corporation that does only a small part of its business within the boundaries of New York, and it would be to the advantage of such a corporation to write off its goodwill.

Like any existing thing of recognized value, goodwill may be the subject of contract. Since it is a property right it may be transferred with the business to which it is an incident or upon which it depends. The statutes of North Dakota provide that: "The goodwill of a business is transferable." The sale of goodwill is authorized by statute in the same state. The proprietor may sell the asset or it may be sold by the court's order. However, it may not be sold by judicial decree or otherwise, unless it be as part of a sale of the business in which it exists.

Goodwill may not be sold separately from the business of which it is a part. Chief Justice Fuller has said that goodwill ". . . is not susceptible of being disposed of independently." This ruling has been followed in a majority of the cases. The underlying theory is that goodwill is inseparable from the business, and, consequently, it is impossible to convey it separately from the concern in which it is involved. However, there are some dissenting opinions. In the case of *Tennant* v. *Dunlop*, 97 Va. 234 (1899), the court maintained that the goodwill might be sold separately from the business plant or property. An analysis of the case reveals the fact that the goodwill in question adhered to certain trade-marks. The court reasoned that the trade-marks might be sold separately from the business and since the goodwill followed them it was sold separately from the business. The weakness of the reasoning lies in the failure to recognize that trade-marks are as much a part of the business property as are the buildings and the machinery. In one case it was held that the goodwill of a business may be sold when no material plant is involved. The same is true when the business transferred is one which is run without a plant. Justice Barrett, in discussing this point, said: "But the goodwill of a business may be sold independently. A physician may sell the goodwill of his practice without selling his office furniture or surgical instruments. So a lawyer may sell the goodwill of his clientage without selling his library. The same applies to the goodwill of a mercantile business, in fact, to goodwill generally." Very few jurists agree with Judge Barrett in his

contention that the goodwill of a mercantile business can be sold independently.

Since the goodwill of a business enterprise may adhere to particular assets, it is possible, in many cases, to obtain this intangible by buying the part of the property with which it is connected. According to Justice Holt: "It is not necessary to purchase all the assets to obtain the goodwill."

There are many decisions to the effect that the contract conveying the business which has the goodwill need not specifically mention that asset. It is understood that this intangible passes with the sale of the property to which it adheres. This may be considered the majority opinion. The few exceptions that are found in the court reports state or imply that the circumstances may be such that the parties concerned may reasonably understand that the goodwill is not included with the tangible assets of the business.

The purchaser who thinks he is buying goodwill with a business and later discovers that he has no such asset has no remedy unless he can prove that there has been fraudulent representation or suppression of facts by the vendor. The rule, "caveat emptor," applies.

The owner of goodwill may transfer it as a gift. Surrogate Fowler has said that ". . . it may be the subject of disposition . . . inter vivos."

Under a general assignment of all a firm's property for the benefit of creditors, the goodwill of the business passes to the purchaser at the assignee's sale. Any purchaser of a business with its goodwill may assign such business and its goodwill to another. In a leading case, the goodwill of a bank which had become insolvent passed to the assignee for the benefit of creditors and was allowed by the court to be transferred by him to third persons together with the real estate and other property to which the goodwill adhered.

In *Bradbury* v. *Wells*, 138 Iowa 673 (1908), the court decided that goodwill may be disposed of by means of a will. Thus, in this respect, goodwill is regarded by the law to be in the same category as other forms of property.

The goodwill of a business is property that may be mortgaged. It has been held that a mortgage of the entire assets of a company does not include the goodwill where such is not the inference and no mention is made of it in the instrument. However, in a case

involving a chattel mortgage of certain specified articles and all other property of every kind and description owned by the mortgagor in his printing office, the mortgage was held by the court to include the goodwill of the business.

If goodwill is an incident to property that is leased, it passes with that property to the lessee, even though it is not specifically mentioned. At the termination of the lease it reverts with the rest of the property to the lessor.

Since goodwill must ordinarily adhere to some principal property or right, the extinction of this property or right operates to extinguish the goodwill dependent upon it. Generally, goodwill terminates with the cessation of a business. It is usually lost when a concern is wound up, its liabilities discharged and its assets collected and distributed.

In case of bankruptcy, the goodwill of the business involved passes to the trustee with the rest of the assets. He is expressly authorized to sell it as part of the property of the bankrupt concern. The decisions touching this point are few in number but they are in agreement. A voluntary transfer estops the transferor from interfering with the value of the goodwill by competition; but, in the case of bankruptcy, when the transfer is involuntary on the part of the owner, the transferor may compete with the purchaser of the business. In a leading case involving a bankruptcy sale, the trustee sold the goods and chattels but made no attempt to sell the goodwill or to sell the business as a going concern. The court ruled that the goodwill did not survive. According to one court decision, the goodwill of a concern was impaired by the appointment of a receiver.

In regard to professional goodwill of the individual there has been considerable lack of uniformity of opinion among jurists. It has been said that goodwill does not enter a business or profession dependent solely on the personal ability, skill, integrity or other personal characteristics of the owner. This view is supported by numerous decisions. Chief Justice Hiscock, in one of the most recent cases involving this phase of goodwill, *Bailly* v. *Betti*, 241 N. Y. 22 (1925), said: "A business dependent solely on the personal skill and professional qualities of the person carrying it on does not possess goodwill." An insurance company was held to have had no goodwill. In this case there was nothing left of the business but the records and Justice Dever decided that it was impossible to reduce these to a money value.

The English courts assert that goodwill is inapplicable to the practice of a lawyer. Lord Chelmsford gave as his reason that the business had no local existence but was entirely personal. This decision was made at a time when locality was considered to be the essential element of goodwill. American courts have decided that commission merchants, lawyers and undertakers have no goodwill that survives. Other American courts have ruled that a professional business may have goodwill but it is attached to the person and not to the place. According to Justice Walker: "It has been stated to be a general rule that goodwill exists in a professional as well as a commercial business, subject to the distinction that it has no local existence, like the goodwill of a trader, but attaches to the person of a professional man as a result of confidence in his skill and ability." In a case regarding the sale of the practice of a dentist, it was held that there was goodwill attached to the person but not to the place of business. This idea was admirably expressed by Surrogate Fowler when he said: "But after a man who has acquired a reputation for great skill or knowledge is dead, persons who go to his office for the purpose of consulting him and availing themselves of his superior skill would not go there merely because the office was still open and occupied by another person who had no reputation for skill or knowledge." The English viewpoint is shown by the words of Vice-chancellor Steven: ". . . but the goodwill of the business of a successful professional man practising alone dies with him."

The constant expansion of the meaning of the term has been such that the present tendency of the courts is to allow goodwill to the professional man. Professional goodwill of an individual business has been sold and these sales have been lawful. According to Justice Cobb: "A physician may sell his goodwill, the goodwill being a property right, and the sale thereof not being against public policy." However, it is well settled that there can not be an involuntary sale of goodwill based upon professional reputation. The principle underlying this ruling is that a professional man has the right to select his clients or patients.

According to the weight of authority at the present time, the goodwill of a commercial partnership is an asset of the partnership as a whole. In case of dissolution it is partnership property subject to sale and the proceeds to distribution. It was formerly held that upon the dissolution of a partnership by the death of one of

its members, the goodwill thereof was not a partnership asset but belonged to the surviving partner or partners on the principle that partnership was similar to joint tenancy. Such was the opinion of Lord Eldon. The present-day doctrine is that the goodwill does not pass to the surviving partner or partners unless there is an express agreement to that effect. It forms a part of the general assets of the partnership in which the estate of the deceased partner is entitled to share. When a partnership is limited in time, the continuing partners are not compelled to make any allowance for the goodwill to a retiring partner because the goodwill is also limited. In an unlimited partnership with an agreement, the retiring partner may share according to that contract. If there is no agreement the courts will not permit the remaining partners to appropriate the goodwill without adequate compensation, and in order to obtain this, will order the goodwill with the other assets to be sold and the proceeds divided. One exception to this is found in a Nebraska decision in which the court allowed the surviving partners to carry on the old business at the old stand without legal liability to account for the goodwill to the representative of the deceased partner, because there was no agreement that they should be so liable. After dissolution each partner may use the old firm name if it does not expose the other partners to risks, provided there is no agreement to the contrary. A surviving partner would not be allowed to carry on a rival business in such a way as to lead the public to believe that it was the old partnership business and in this manner appropriate all the goodwill. If he so desires, a partner may sell his share of the goodwill with his share of the business to the other partners. The court held that the goodwill should not be taken into consideration in the accounting upon the dissolution of a partnership which had been conducted in the name of one partner although there were other partners who had kept their names secret. It is well settled that one partner, without express agreement to that effect, may not dispose of the entire goodwill of a firm.

The authorities on partnership agree that a professional partnership may have no goodwill. Judge Story said: "It seems that goodwill can constitute a part of the partnership effects or interests only in cases of mere commercial trade or business; and not in cases of professional business, which is almost necessarily connected with personal skill and confidence in the particular partner." According to Bates: "Goodwill is not strictly applicable

to a professional partnership, for the business has no local existence, but is entirely personal, consisting in a confidence in the integrity and ability of the individual." In a recent case, Justice Hiscock said: "It has, however, never been held that a business dependent solely on the personal skill and professional qualifications of the persons carrying it on possessed a goodwill or copartnership name which could be sold or transferred to any one who might desire to purchase on a sale. The contrary proposition is abundantly established." In a case involving a partnership engaged in a commission business, the court ruled that, in the absence of special contract, there was no such thing as goodwill in that type of partnership.

Business corporations may have goodwill connected with their property, business or other rights. It belongs to the corporation as an entity and may be transferred by the organization. The old theory was that goodwill could not enter into and form an element in the value of shares of stock. At present the courts allow it to be carried on the books as an asset and to be considered in determining the value of common stock. It has market value and may be accepted in payment of a stock obligation. A stockholder may not transfer the entire goodwill of a corporation. However, since the goodwill adheres to the corporate business, a stockholder sells whatever interest he may have in the goodwill of that business when he sells his stock.

Since goodwill is property and an asset, it must have value. Chief Justice Fuller, of the United States supreme court, has said: " . . . goodwill is in many cases a valuable thing . . ." Decisions of the American courts, before and after the one quoted, are in agreement on this idea. In some instances, as in the newspaper business, the goodwill may be the most valuable asset of the concern. A public-service monopoly is an exception. The rulings of the public-utility commissions have been that no allowance will be permitted for goodwill in a valuation for rate making. The theory is that where there is no competition there can be no goodwill because customers are retained under such conditions by compulsion, and not by their voluntary choice. However, where competition actually exists goodwill is as important an asset of a public-utility company as of any other concern.

In regard to the determination of the value of goodwill, the first question is whether or not that intangible asset is of such a nature that it may be valued. Justice Spring said: "While it is an in-

tangible asset it is susceptible of being measured at a money value." The same idea is brought out in an English decision of a much earlier date. The courts of both England and the United States agree on this point.

The next question which arises is whether or not it is possible to value goodwill. On this point Circuit Judge LaCombe has expressed his opinion in these words: " . . . in some way or other it must be practically possible to determine what that value is." However, Justice Braley has maintained that " . . . no rule can be laid down by which the goodwill in all cases can be ascertained and its value fixed with mathematical precision and accuracy." Most jurists agree that it is possible to determine the approximate value of goodwill.

The placing of a value on goodwill may be far from an easy task. According to Chief Justice McBride: "It is very difficult to approximate the value of goodwill. . . . The data for estimating the value of the business are always more or less uncertain." In a recent case, Surrogate Fowler said: "There is no more speculative or intangible subject of valuation than goodwill. It is difficult to fix from its very nature."

The valuation of goodwill is so perplexing because it is necessary to look forward and to attempt to judge the future by the past, when the past is no sure guide to the future on account of the almost infinite number of possibilities of variation in the circumstances which have an influence on the value of this extremely shadowy form of property. Any slight change in the surrounding conditions will increase or diminish the value of goodwill.

The courts have not laid down any inflexible rule for the determination of goodwill value. The tendency seems to be to decide each case on its merits and circumstances. From the very nature of the property it is evident that the question must, within proper limits, be left to the jury. It is impossible to make a rule that will cover all the circumstances which it may be necessary to consider when this asset is given a value. When the matter is given over to the jury it is essential that the conclusion be based upon legitimate evidence establishing value and it is the concern of the court to see that this evidence is pertinent and adequate.

In a valuation of goodwill, the profits are necessarily taken into account. It might not be equitable to take the profits of any one year because extraordinary circumstances might cause the profits

for that year to be abnormally large or small. According to Allan in his *Law of Goodwill*, "The usual basis of valuation is the average net profits made during the few years preceding the sale." The courts of the United States have usually ruled that the average of the three preceding years be taken. In the matter of Halle, 170 N. Y. S. 898 (1918), Surrogate Fowler insisted that the profits of four years be used in determining the average. The United States treasury department, in computing the March 1, 1913, value of goodwill for income-tax purposes, has used A. R. M. 34 very extensively. This provides that the profits for the five years preceding the computation be used. Jurists maintain that exceptional profits have no place in the computation of this average and if there happens to be an abnormal year among those taken for the basis of the average there is good authority for excluding it from such computation.

In numerous decisions the courts have held that opinion evidence of experts in regard to the value of goodwill is incompetent. Nevertheless, it has been admitted in some cases. Chief Justice McBride expressed the majority viewpoint when he said: " . . . conditions being shown . . . are stronger evidence than the opinion of the so-called interested expert, yet the authorities seem to be generally to the effect that such testimony is admissible for what it is worth." Owners and operators of a business are considered competent witnesses of the value of the goodwill. In regard to other witnesses Justice Dunbar said: " . . . the goodwill of a concern is a character of property so indefinite that a statement of its value must necessarily be regarded by any man of any business acumen whatever as very largely a matter of opinion." However, it seems that the testimony of competent witnesses would aid the jury in arriving at an approximately correct valuation.

Absence of competition must be given careful consideration when goodwill is given a value. The part played by this factor will vary according to the type of the business. In some cases the value of this asset may depend almost entirely upon freedom from competition with the seller of the concern. In the United States, unless there is an agreement to the contrary, the courts allow the seller of a business with its goodwill to set up a similar business but do not permit him to solicit his old customers, although he may trade with them if they come without solicitation on his part. Justice Tyler, in speaking of goodwill valuation,

said: "How far its value may be affected by competition . . . is an element, of course, to be taken into consideration in the fixing of such value."

A few other factors affecting the value of the goodwill of a business have been recognized by the courts in their decisions. The reputation of a concern for fair dealing has an influence on the profits and the goodwill, so it must be given consideration in the valuation of that intangible asset. Length of time that the business has been in existence would ordinarily have an effect on the value of its goodwill. Great concerns like Marshall Field & Co., Tiffany & Co., and Montgomery Ward & Co., which have been successful over a long period of years, have a better basis for goodwill than the new and untried organization. If a business is dependent upon a lease, the length of time which the lease has yet to run, the chance of renewal and the terms thereof have an influence on the value of the goodwill of that business.

Several methods of determining the value of the goodwill of a business organization have been approved by jurists. In the matter of a decedent's estate the courts have ruled that the result of inventory and appraisal is prima facie evidence of the value of the goodwill. The supreme court of the United States, in a very unusual decision, maintained that goodwill could be computed by taking the difference between the amount actually invested and the market value of the stock. In this case the goodwill adhered to a franchise and the conditions were such that it was impossible to compute the value except by the method adopted. According to the majority of American court decisions, the most common basis for the valuation of this intangible is a number of years' purchase of the profits as averaged over a period of three normal years. The English view was given by Lord Chelmsford when he said: "Where a trade is established in a particular place, the goodwill of that trade means nothing more than the sum of money which any person would be willing to give for the chance of being able to keep the trade connected with the place where the business has been carried on."

As to the number of years' purchase of the average annual profits there has been much difference of opinion among the judges. Valuations based on more than five years' purchase have not ordinarily been sanctioned by the courts although there is a slight tendency to go beyond five years in cases of concerns that have a superior organization and executives who are unusually capable.

From a survey of the American cases in point, it seems that most of the jurists have used from two to six years; the number depending upon the type of the business, its duration at a particular location and its reputation.

The English courts, in a case involving a bank, decided that the goodwill was equal to one year's purchase of the annual profits. In the matter of Silkman, 105 N. Y. S. 872 (1907), it was ruled that two years' purchase of the average annual profits was proper. Surrogate Thomas made a similar decision in the matter of Rosenberg, 114 N. Y. S. 726 (1908). When the International Harvester Co. was organized there was a contract to the effect that the goodwill should equal the profits of the two preceding years plus ten per cent. The United States commissioner of corporations commented on this in the following words: "This method of valuing goodwill was more or less commonly used by manufacturers." In an English case, Justice Stirling said: "It seems to me that the competition and a desire to exclude rivals in trade would lead a brewer to give not less than three years' profit." Most of the American decisions approve of the use of three years' purchase of the average annual profits as the value of the goodwill of a business concern. In *Pett* v. *Spiegel*, 202 N. Y. S. 650 (1923), a case which concerned a real-estate corporation, the court considered that a five years' purchase of the average annual profits was fair to both parties. In *Von Au* v. *Magenheimer*, 110 N. Y. S. 629 (1908), which is considered to be one of the leading American cases on goodwill valuation, the jury decided that the goodwill was worth five times the average net earnings. The court approved of a ten years' purchase of the average annual profits in valuing the goodwill of a large New York jewelry concern.

After the average annual profits of the business have been determined and the number of years' purchase of such profits has been settled, the factor of interest on the invested capital arises. The accountant, in his computation of profits, does not include interest on the invested capital as an expense of the business. The result is that the interest is included in the profits as shown by the income statement. From the viewpoint of the purchaser the business is not making an excess profit until it makes more than enough to equal what he could obtain by investing his money in safe securities plus compensation for risk in the particular field. Consequently, in determining the amount of the net average

annual profits to serve as a basis for computation of the goodwill, it is necessary to deduct from the average annual profits, as shown by the statement of the accountant, a fair rate of interest on the invested capital. According to Justice McLaughlin: "There are several authorities which indicate that interest on capital ought to be deducted from the average profits of a business before using such profits as a basis for determining goodwill." This statement is supported by many decisions.

If the management which has developed the goodwill does not go with the business when it is sold a deduction must be made from the average net annual profits, as lessened by interest on the invested capital, of a fair salary for managerial services. In *Kindermann* v. *Kindermann*, 183 N. Y. S. 897 (1920), Justice Giergerick maintained that salaries of officers should not be included in profits for estimating goodwill even though such salaries absorbed the greater part of the operating profits. Several brothers were the officers and only stockholders and in anticipation of the goodwill valuation they voted themselves salaries large enough to reduce the operating profits to a low figure so that a low value would be placed upon the goodwill of the corporation. Justice Giergerick approved of this procedure and he is supported in his action by several New York decisions.

The law of goodwill valuation may be summarized as follows: Take the average annual profits of the three preceding years, deduct a fair rate of interest on the invested capital and a fair salary for management, and multiply the remainder by some arbitrary number which will depend upon the character of the business. It is permissible to capitalize the remainder at an arbitrary per cent. The final result should be the same under both methods.

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A. P. RICHARDSON, *Editor*

EDITORIAL

A Dangerous Development of Corporation Laws

In the course of a recent tour of cities in the middle west by officers of the American Institute of Accountants for the purpose of meeting with Institute members and other accountants, the president of the Institute drew attention to a comparatively novel trend in legislation which he felt constituted a serious danger to the business world in America. This peril is exemplified in an enactment of the Delaware legislature during the session of 1929, providing for further laxity in the determination of the use which corporations may make of cash received in payment for capital stock without par value. For some time there has been evident a tendency toward a liberality and an absence of restraint in corporate law, which may involve a most serious menace to all business. Delaware is merely one of the more complacent states. It is not necessarily the worst; there are several others in which the acquiescence of legislators is remarkable. But the Delaware incident will serve for purposes of illustration, and it is of interest to read what is written in the newly amended corporation law, which went into effect March 22, 1929. Section 14, as revised, reads:

> Subscriptions to, or the purchase price of, the capital stock of any corporation organized or to be organized under any law of this state may be paid for, wholly or partly, by cash, by labor done, by personal property, or by real property or leases thereof; and the stock so issued shall be declared and taken to be full paid stock and not liable to any further call, nor shall the holder thereof be liable for any further payments under the provisions of this chapter. And in the absence of actual fraud in the transaction, the judgment of the directors, as to the value of such labor, property, real estate or leases thereof, shall be conclusive.
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> As to corporations incorporated prior to April 1, 1929, shares of capital stock without par value, whether common or preferred or special, may be issued by the corporation from time to time for such consideration as may be fixed from time to time by the board of directors thereof, pursuant to authority conferred by the certificate of incorporation or, if such authority shall not be so conferred on the board of directors, then for such consideration as may be fixed by the consent in writing of, or by vote of, the holders of record of two thirds of the total number of shares of each class of stock then outstanding and entitled to vote in respect thereto, such vote to be given at a meeting called for that purpose in such manner as shall be pre-

scribed by the by-laws. As to corporations incorporated on or after April 1, 1929, shares of capital stock without par value, whether common or preferred or special, may be issued by the corporation from time to time for such consideration as may be fixed from time to time by the board of directors thereof, unless in the certificate of incorporation the power to fix such consideration shall have been reserved to the stockholders, in which event such power shall be exercised by the stockholders by consent in writing or by vote of the holders of record of two thirds of the total number of shares of each class of stock then outstanding and entitled to vote in respect thereto, said vote being given at a meeting called for the purpose in such manner as shall be prescribed by the by-laws; provided that, although such power has been reserved to the stockholders, the directors shall nevertheless have power to fix such consideration for the first issue of stock, and such issue shall not exceed ten per centum of the whole amount of such stock authorized by the certificate of incorporation. Any and all shares without par value so issued for which the consideration so fixed has been paid or delivered shall be deemed full paid stock and shall not be liable to any further call or assessments thereon, and the holders of such shares shall not be liable for any further payments in respect of such shares under the provisions of this chapter.

Any corporation may by resolution of its board of directors determine that only a part of the consideration which shall be received by the corporation for any of the shares of its capital stock which it shall issue from time to time shall be capital; provided, however, that, in case any of the shares issued shall be shares having a par value, the amount of the part of such consideration so determined to be capital shall be in excess of the aggregate par value of the shares issued for such consideration having a par value, unless all the shares issued shall be shares having a par value, in which case the amount of the part of such consideration so determined to be capital need be only equal to the aggregate par value of such shares. In each such case the board of directors shall specify in dollars the part of such consideration which shall be capital. If the board of directors shall not have determined (a) at the time of issue of any shares of the capital stock of the corporation issued for cash, or (b) within sixty days after the issue of any shares of the capital stock of the corporation issued for property other than cash what part of the consideration for such shares shall be capital, the capital of the corporation in respect of such shares shall be an amount equal to the aggregate par value of such shares having a par value, plus the amount of the consideration for such shares without par value. The capital of the corporation may be increased from time to time by resolution of the board of directors directing that a portion of the net assets of the corporation in excess of the amount so determined to be capital be transferred to capital account. The board of directors may direct that the portion of the excess net assets so transferred shall be treated as capital in respect of any shares of the corporation of any designated class or classes. The excess, if any, at any given time, of the total net assets of the corporation over the amount so determined to be capital shall be surplus.

Protection for the Directors

Lest there should be any misunderstanding of the intent of the law or any overscrupulous director should hesitate to pay out as dividends capital under its new name, surplus, section 34 provides:

Dividends; Reserves:—The directors of every corporation created under this chapter, subject to any restrictions contained in its certificate of incorporation, shall have power to declare and pay dividends upon the shares of its capital stock either (a) out of its net assets in excess of its capital as computed in accordance with the provisions of sections 14, 26, 27 and 28 of

> this chapter, or (b), in case there shall be no such excess, out of its net profits for the fiscal year then current and/or the preceding fiscal year; provided, however, that if the capital of the corporation computed as aforesaid shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaired. Subject to any restrictions contained in its certificate of incorporation, the directors of any corporation engaged in the exploitation of wasting assets may determine the net profits derived from the exploitation of such wasting assets without taking into consideration the depletion of such assets resulting from lapse of time or from necessary consumption of such assets incidental to their exploitation.

This seems broad enough in all conscience—or perhaps one should say, out of all conscience—but merely to remove any possibility that a doubt or a fear may linger in some directive mind a new clause has been written into the law, which reads as follows:

> A director shall be fully protected in relying in good faith upon the books of account of the corporation or statements prepared by any of its officials as to the value and amount of the assets, liabilities and/or net profits of the corporation, or any other facts pertinent to the existence and amount of surplus or other funds from which dividends might properly be declared and paid.

In other words, if $100,000 is received by a company incorporated under the laws of Delaware in payment for capital stock of no par value, and if there is no other class of stock, and the liabilities are, let us say, $10,000, the directors may determine that $90,000 of capital is no longer capital but is now surplus, and they may, if they deem it expedient or salutary, declare the full amount of $90,000 in the form of a dividend to the stockholders. And, if some stockholder is an old-fashioned person who fails to see the advantage to the company of distributing all its assets in the form of dividends and decides to bring suit against the company for impairment of capital, negligence or other offense against decency, he can not succeed in his suit because the directors, who are the persons directly responsible, are exonerated by the law and held harmless.

Principle of No-par-value Stock Is Sound

When the first laws authorizing the issuance of shares without par value were enacted, the innovation was generally acclaimed, and it was hoped that a way had been found by which the anomalous and misleading fiction of par value could be

avoided and the interests of investors protected. But like many fine ideas, the no-par-value law has not developed in practice as it was expected to develop. It has become the plaything of a hundred corporation lawyers who have special purposes to serve. Nearly every legislature is besieged with requests for amendments of corporation law which will permit the individual besieger to do some particular thing which existing law prohibits or at least prevents. Lawyers are generally supposed to advocate the interests of their clients, and it must be confessed that corporation lawyers as a whole have not been indifferent to their loyalty to the corporations which employed them. It may even be affirmed without much fear of contradiction that a great number, if not actually a majority, of the corporation lawyers who are engaged in the effort to influence legislation are animated solely by a desire to bring about the enactment of a law or an amendment which will serve primarily the interests of one corporate entity. It is not on record that the lawyers representing any one corporation have often devoted their attention with marked perseverance to the furtherance of legislation of purely general merit.

Recent Changes Are Perilous

The no-par-stock laws have been amended time and time again and some of them have assumed so great an elasticity that they are now justly regarded as being all permissive. Some, such as the law in Delaware to which we have referred, do not deserve the title "law" at all. They are merely licence. As we understand the principles of jurisprudence, the purpose of a law is to define what may not be done, leaving it to the good judgment of the public to do those things which are not forbidden. Turn to any code of laws and one will find that they are almost exclusively in the form of "do not." The fundamental code of Sinai is all prohibitive, with one exception. Such a law as that in Delaware purporting to govern the management of corporations seems to be almost wholly concerned with explaining what may be done in contravention of what should be done. It is a great pity that the no-par-stock law has been so bandied about that it has lost almost all its virtue. It might have been a splendid means of permitting the fair expression of the value of stock ownership, but when it reaches so low a level that it specifically allows impairment of capital and absolutely unjustifiable distribution of capital in the form of dividends, the time has come

to cry "Halt!" Every accountant knows that the things which are being done under some no-par-stock laws are at utter variance with sound principles of business and accounting. Perhaps the lawyers who are chiefly responsible for the enactment of our multiplicity of legislation do not fully understand how grave is the danger into which their acts are leading business. As has been said, they have first their clients to consider. The rest of the public can go hang. But the accountant is in a different category. He knows the fundamental laws upon which successful business is based, and he knows positively that the diversion of capital for the purpose of building up a surplus which may be distributed in the form of dividends, when in point of fact no profits may have been earned, is a certain means of wrecking any business.

What the Accountant May Do about It

This leads to the broader question of the duty of the accountant. Obviously no reputable accountant will be involved, even indirectly, in the impairment of capital of a company, whatever the law of an individual state may say about the matter. If a law justified theft one would scarcely argue that thieving is good morality. At present the country is going through an era of great financial prosperity. There may be differences of opinion as to the condition of industry and commerce, but in the realm of finance there can be no serious question that prosperity to an extraordinary extent exists. Capitalization is one of the great problems which accompanies such a wave of prosperity. New companies are formed; old companies are amalgamated; holding companies are created to control groups of lesser companies. And one of the most constantly considered elements of the problem is that of capital structure. That in turn brings in its train the highly controversial question of what may be justly classified as earned surplus. This is a field in which the accountant is the only man competent to guide affairs and it is, therefore, of the utmost importance that the accounting profession should give thought to the modern trend of legislation, and especially to the dangers which are created by the new laxity in no-par-stock laws. Legislators do not understand, lawyers as a rule are quite innocent of any knowledge of business principles, and business men themselves are far too much concerned with other matters to give serious consideration to such apparently theoretical questions as the difference between capital and surplus. What is the duty

of the accountant? In the first place, it seems clear that his voice should be heard in protest against anything which may impair the capital of a company. He should decline to have anything to do with any company which would take advantage of iniquitous laws to perform iniquitous acts. But on the other hand one knows that there may be a few men who will accept appointment as auditors if the fees be large enough, whatever may be the ethics of the corporation's directors. It seems on the whole that the most effective method of preventing disaster would be to bring to the attention of lawyers, bankers, business men, etc., the gravity of the peril which exists and to solicit the support of all who are related to business for an educational campaign to prevent legislators from making fools of themselves and wrecks of business. And, lest some of our readers should feel that the laws of their own states are so superior to the laws of Delaware that there can be no possible comparison, it might be well to suggest that the accountants of every state should look carefully into the corporation laws to see exactly how much latitude there may be for the incorporation of companies in a manner which will place the interests of the investing public in jeopardy. The danger is not imaginary; it is real and it grows. In order to avoid any possibility of misunderstanding, it should be pointed out that there are hundreds of companies operating under no-par-stock laws in a manner which is entirely above reproach. It is not with the companies and their acts that we are primarily concerned, but with the laws which permit corporations to do things which no decent corporation would do.

An Arkansas Law and the Accountant

In the May issue of THE JOURNAL OF ACCOUNTANCY we ventured to express warm approval of a section of a new statute in Arkansas. The law in question levies a tax upon incomes and provides that whenever a return is filed and a certified public accountant, duly authorized under the laws of Arkansas, certifies that he has made an audit of the taxpayers' records for the income year and has prepared the return to which his certificate is attached, such return shall be accepted by the commissioner as prima facie true and correct. It did not occur to us that anyone would have serious quarrel with such a provision, but we have received a letter from C. O. Wellington, a member of the council of the American Institute of Accountants, who

thinks that the Arkansas law is without merit. Mr. Wellington writes:

> Possibly your question on page 364 of the May number of THE JOURNAL, "Where, then, can one find cause for opposition to the progressive plan of Arkansas?" was inserted for the purpose of inviting a reply and starting discussion. I, for one, certainly find myself very seriously in disagreement with the unqualified praise you appear to give the section of the Arkansas law which you quote in your editorial.
>
> If accounting were an exact science and true income was capable of exact measurement, there would be considerable merit in the suggestion, but, as has been pointed out again and again, many matters that come up in accounting are solved as questions of opinion and on some points the opinion of one competent accountant might be substantially different from the opinion of another accountant equally competent. However, what is of more importance is that the administrative officers for the federal government, and presumably for all the states having income-tax laws, naturally interpret each law as passed so that every doubtful point is decided in favor of the government and regulations under each law are issued accordingly. If, therefore, the accountant preparing the return is to be any more than a mere clerk putting together certain figures taken from the books, he must often find himself in disagreement with regulations and he must often advise his client that, in his opinion, certain regulations are contrary to the letter or spirit of the income-tax law and, when tested in the courts, will be upset. The experience we have all of us had with the federal government in the last fifteen years is ample evidence on this point.
>
> In my opinion, instead of a movement such as that in Arkansas being encouraged, it should be very definitely discouraged, as it puts the accountants in the false position of trying to serve the government and the client at the same time. While, of course, no reputable accountant will misstate the facts, he will often disagree with the government authorities as to the interpretation of the law and regulations bearing upon those facts, and he should be free to advise the client for the client's own best interest and not be subject to any penalty or even criticism if he fails to follow every regulation laid down by the taxing authorities. I believe if an accountant is competent he will find many instances in which he will and should refuse to follow the income-tax department's interpretation of the law.
>
> I am very sorry that THE JOURNAL has given even this much support to an idea which I believe to be fundamentally unsound until those who pass our laws, and particularly those who administer them, are willing to decide income-tax questions on the basis of fairness and equity. If that time should come, which I doubt under our present type of government, I would then agree that accountants could coöperate as suggested, but, in the meanwhile, with the taxing authorities leaning so heavily in favor of the government and against the taxpayer, it is necessary, to have even an approach toward justice, for the taxpayer and the accountant to lean heavily the other way.

In reply to the comments of Mr. Wellington let us say at once that the notes which are the subject of his criticism were not inserted for the purpose of starting a discussion. We welcome discussion, but this did not seem a good starting point. We looked for unanimity. However, having studied carefully the objections which our correspondent raises, we confess to an inability to understand the cause of the protest. There is nothing in the Arkansas law to say that a certified public accountant who signs

a tax return becomes a mere clerk. There is nothing in the law to indicate that the accountant must give up an individual sense of right and wrong and follow a given form. There is nothing in the Arkansas law to discourage the expression of absolute disagreement with anything that the authorities of Arkansas may lay down in the form of regulations. Every accountant, of course, knows that there are many times when it is imperative that he should differ with the federal government, the state government, or any other government—and we do not feel that the condition under what Mr. Wellington describes as "our present type of government" is peculiarly unfair. It seems to be quite commonly believed that most of the persons charged with the duty of administering tax laws handle a very difficult task with a good deal of tact and patience. No one loves a tax gatherer, and there does not seem to be much reason why one should, but that is no cause for saying or believing that officers of the government are necessarily wrong. The taxpayer himself, his attorney or his accountant may be absolutely wrong. All that the Arkansas law intends and says is that the statement of a public accountant shall be accepted as "prima facie true and correct." That does not involve a false position at all; it does not call for serving the government and the client at the same time, although it may be said parenthetically that the accountant should serve the government and the client at the same time. Fair play calls for fairness to all the players. We differ with reluctance from so able a friend as Mr. Wellington, but having read his criticism we adhere with utter stubbornness to our first contention that the law of Arkansas is a good law and worthy of imitation.

Terminology Department

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

The special committee on terminology submits the following tentative definitions for consideration and criticism. Letters may be addressed to the committee in care of THE JOURNAL OF ACCOUNTANCY.

VALUE—UNDEPRECIATED:

Value before making any deduction for depreciation that may have been suffered. The term does not indicate whether the value is based upon cost, appraisal or assessment, but means only that depreciation has been ignored. The term needs further qualifying words to indicate whether cost or other value has been taken as the basis.

INCOME—ACCRUED:

Income arising from rentals, royalties and interest, and from some other sources may be receivable at stated dates; if accounts be made up at dates other than those on which such income becomes due and receivable an amount of income corresponding to the length of time elapsed since the last due date may be taken up as accrued income. Dividends, even on cumulative preferred stocks, should not be taken up unless they have been declared.

INCOME—COMMUNITY:

This term is used to describe income that accrues jointly to two or more persons; usually it is income that accrues to husband and wife. Under the laws of some of the states all income of husband and wife is community income and federal tax regulations have allowed in such cases separate income-tax returns for husband and wife, each returning half of the total income.

INCOME—DEFERRED:

This term is used in accounting to describe income which has been received but is really applicable to a future period.

INCOME—ESTATE:

The income of an estate, as computed for the purpose of accounting to a court, may differ materially from the income as it would be computed for commercial purposes. Laws and court decisions vary in the several states, the treatment of dividends, especially stock dividends, often being at variance with both income-tax regulations and commercial practice. The importance of the divergencies of treatment lies in the fact that estates may have beneficiaries who receive only the estate income, and moneys that ordinarily would be received as income may, in the case of estates, be considered as accretions to capital.

INCOME—GROSS:

In general, income as computed before certain deductions are made. The deductions to be made vary according to circumstances, but their

general character is that of overhead, management, financing and other indirect expenses.

INCOME—JOINT FACILITIES:

A term used in railroad accounting to signify the carriers' proportion of revenues from joint facilities operated by other carriers, including union station companies.

INCOME—MISCELLANEOUS:

A term applied to sundry income not derived from the ordinary operation of a business, although it may be incidental thereto. Sale of junk, incidental rent of an unused part of a building, small amounts of bank interest and other odd items of income, not of enough importance to appear separately, are thus classified.

INCOME—NET:

Income, after making all deductions; dividends are not a deduction, as they are payable out of surplus, not directly out of income.

INCOME—NON-OPERATING:

Income that is derived from sources other than the general operation of a business. (See "Operating income.")

INCOME—OPERATING:

Income derived from the general operation of a business. It is applied to the income of railways, arising from the operation of the lines, and excludes both other income and certain expenses. It is not synonymous with net profit, but rather indicates a stage in the profit-and-loss account where all direct cost of operation and all direct income from operation has been taken into the account, and no more.

INCOME—OTHER:

A vague term, similar in meaning to miscellaneous income; sometimes it is used to cover large items of income not arising from the operations that have been set forth in detail in a profit-and-loss account. This classificaton of relatively large amounts is undesirable without some further explanation.

INCOME—SINKING-FUND:

Like all other funds, sinking funds are made up of cash or readily marketable securities; the interest and other income from these assets are the sinking-fund income, and should be added to and become part of the fund. If a sinking fund be provided for the retirement of bonds it may be used to purchase some of the bonds to be retired; in that case the bonds are not canceled, but the coupons, when due, are paid into the fund so that the fund may not be deprived of the income to which it is entitled.

INCOME—TAXABLE:

Income as computed and subjected to tax under the laws and regulations of the federal or state bureaus of internal revenue. They differ from commercial standards; indeed they differ in different years, as the laws and regulations change. Besides having certain rules for computing depreciation, depletion

and other expenses, the federal and some state laws exempt from taxable income interest on municipal obligations, some interest on federal obligations and in some circumstances dividends of domestic corporations, etc. All these provisions must be considered and corresponding adjustments made before taxable income is determined. Its total may be less or greater than true income.

INCOME:

The following terms do not seem to have any special technical meaning, although they have been used: Income—annual, prepaid, primary, secondary, unearned.

CAPITAL—AUTHORIZED:

The articles of incorporation of corporations state the amount of capital stock that may be issued; the certificate of incorporation authorizes the issue of this amount, which is the amount of authorized capital.

CAPITAL—CALLED-UP:

The amount of capital authorized may not at once be needed; either some part of the stock may remain unissued or stock may be issued on such terms that only part of the price is paid at once, the remainder being subject to call when needed. The amount paid in plus any calls remaining unpaid constitutes the called-up capital.

CAPITAL—CIRCULATING:

This expression appertains to economics rather than to accounting. It has been defined as "Wealth used in the production of commodities, the efficacy of which is exhausted by a single use such as (a) raw materials and (b) cash for the payment of wages collectively used to produce a manufactured article. The term 'circulating' is derived from the circumstance that this portion of capital requires to be constantly renewed by the sale of the finished articles and repurchase of raw materials, etc." The term is used by Hatfield as synonymous with "floating capital".

CAPITAL—DEBENTURE:

Capital derived from the issue of debentures.

CAPITAL—DEPARTMENTAL:

Some corporations separate their investment among several departments, the intention being to ascertain the relative return on capital from each department. In some cases interest on such capital is charged to departments.

CAPITAL—FIXED:

A rather vague term, used in economics more than in accounting, meaning capital invested in plant, buildings and other fixed assets.

CAPITAL—FLOATING:

Equivalent to "circulating capital". Capital invested in current assets.

CAPITAL—INVESTED:

This term does not mean the amount of capital originally invested, but the whole sum of capital originally invested plus the amount of accumulated profits retained in the business. Under the profits-tax laws of earlier years "invested capital" was a highly technical term, the exact meaning

varying somewhat from year to year. It might include goodwill not on the books and might exclude assets that were on the books.

CAPITAL—ISSUED:

This is more properly called capital stock, issued. It means that part of the authorized capital represented by the shares of stock actually issued for cash or other consideration.

CAPITAL—ISSUED AND SUBSCRIBED:

Whereas the term "issued capital" should apply only to capital stock actually issued for cash or other consideration, excluding treasury stock, it is not unknown for corporations to authorize the issue of capital stock, go through the form of issuing certificates for the whole amount, sell part and retain part in the treasury, calling the treasury stock issued stock. In such cases the phrase "issued and subscribed" means that part of the issue that has actually been sold, whether fully paid for or not.

CAPITAL—NEGATIVE:

This term is concerned with economics, not accounting. Elsewhere defined as follows: "Negative capital is composed of credit, such as the right to demand payment of a debit"; and as "The amount of credit which a trader or firm can obtain". (See "Positive capital.")

CAPITAL—NOMINAL:

The amount of capital represented by the par value or declared value of the issued stock. This term has a special application in income-tax laws, companies with nominal capital, deriving their income from personal services, being allowed special treatment. This was of greater importance when excess-profits taxes were levied.

CAPITAL—ORIGINAL:

The amount of capital actually paid in, excluding increases due to the retention of any accumulated gains.

CAPITAL—PAID-IN:

The amount of capital actually contributed, in cash or assets, by the stockholders of a corporation

CAPITAL—PAID-UP:

More properly, capital stock, paid up. See "Capital—called-up." This differs from called-up capital in that it excludes calls that have not been met and includes capital that may have been paid in advance of call.

CAPITAL—POSITIVE:

This term applies to economics, not to accounting. It has been defined as "that which consists of material assets, i.e., cash, buildings, land, stock, plant, machinery"; and as follows: "Positive capital is represented by money, land, buildings, stock in trade and all material objects".

CAPITAL—REGISTERED:

The amount of capital authorized by the certificate of incorporation of a company, registered with the secretary of state.

CAPITAL—SHARE:

Capital represented by shares of capital stock.

CAPITAL—STATED:

The definition of this term has been the subject of heated controversy, but it may be said that in the case of corporations with stock of par value it is the face value of the capital stock issued, and that in the case of companies with stock without par value it should be the total amount received, in cash or other assets, for the shares issued. Unfortunately the laws of the several states differ widely on this subject, some states permitting a part of the amount received for stock issued to be set aside not as permanent capital but as surplus, even as surplus from which dividends may be paid. In such cases the stated capital is subject to restrictions and regulations imposed by the laws of the various states, generally, that part of the proceeds of the sale of capital stock which the directors declare to be the capital of the corporation.

CAPITAL—SUBSCRIBED:

Upon the formation of many corporations the entire amount for which the stock is sold is not immediately needed; in such cases those acquiring stock subscribe for, or agree to purchase, a certain amount of stock. Usually a part of the purchase price is paid at the date of subscription and the remainder either at an agreed subsequent date or in instalments when called.

CAPITAL—UNCALLED:

The amount that stockholders may be called upon to pay for capital stock to which they have subscribed, in addition to the amount for which they already have been called upon.

CAPITAL—UNISSUED:

(See "Capital, issued.") That part of the authorized capital that has not yet been issued for cash or other assets.

CAPITAL—UNPRODUCTIVE:

This term applies to economics, not accounting. Capital that is invested in assets not producing any income either directly or indirectly, such as vacant land, mines not operated, etc.

CAPITAL—WATERED:

Where corporations have issued stock largely in excess of the intrinsic value of the assets which it represents the stock is said to be watered. In many—perhaps a majority—of cases the corporation issuing such watered stock is a holding company, owning the stock of one or more other companies, so that the disparity between the stock it issues and the tangible assets which are the ultimate basis for the issue is not readily apparent.

CAPITAL—WORKING:

The capital that is available for current use in the operation of a business; substantially, the excess of current assets over current liabilities.

CAPITAL:

In addition to the foregoing, the following expressions have been used. None has an accepted technical meaning, and the committee does not care to countenance their use as accounting terms: Capital—active, available, equated, general, landed, loan, loanable, net, non-landed, operating, quick.

Income-tax Department

EDITED BY STEPHEN G. RUSK

An accountancy practitioner tells a not uncommon story about the disastrous consequences of participation in tax matters by unskilled advisors. A client of this practitioner, for reasons adequate to himself, sought the services of an employee of a bank who augmented his income by rendering tax service to patrons of the bank. The bank employee made out the tax return and advised the client that the work formerly done by the accountant was improper, containing errors which had resulted in overpayment sufficiently large to cause the client to demand an explanation of the accountant.

The subject of controversy was an intricate tax problem, and it required considerable research on the part of the accountant to reveal the erroneous deductions made by the bank employee in arriving at his false conclusions. Fortunately, by unquestionable demonstration of the bank clerk's mistakes, the accountant regained the confidence of his client and, incidentally, an additional fee.

It seems deplorable that responsible practitioners must be subject to annoyance of this kind caused by unsubstantiated assertions of unqualified amateurs who are merely trying to pick up a little extra money. Doubtless unmeritorious work will soon be recognized and merit will surely be rewarded in the course of time, but much damage may be done in the meantime and we believe that accredited practitioners should consider it a duty to warn clients of the dangers of accepting the statements of incompetent persons.

SUMMARY OF RECENT RULINGS

The value of bequests in trust to charitable purposes following a life estate is deductible from the decedent's gross estate, where the residuary estate was bequeathed to the testator's wife for her life with authority to use from the principal any sum "that may be necessary to maintain her suitably in as much comfort as she now enjoys," the principal that could be so used being fixed in fact and capable of being stated in definite terms of money, and the income of the estate being more than sufficient to maintain the widow as required. (*Ithaca Trust Co., executor and trustee under the will of Edwin C. Stewart,* v. *United States.* U. S. supreme court).

Additional salaries claimed in 1919 as and for years prior thereto, not previously authorized, and amount claimed in excess of that allowed as reasonable compensation for 1919 services, are not deductible. (U. S. circuit court of appeals, fourth circuit, *Adams, Payne & Gleaves, Inc.,* v. *Commissioner.*)

Additional compensation voted in 1920 by the board of directors of a corporation "for past services" "as an officer thereof, and in any other capacity," held, on the evidence, to be reasonable compensation for services, is deductible on the accrual basis in the year voted, the liability therefor having been incurred during the taxable year, and the statute not limiting deduction for compensation for personal services rendered to those rendered within the taxable year. (U. S. circuit court of appeals, fourth circuit, *Ox Fibre Brush Co.* v. *Commissioner.*)

Beverage taxes voluntarily paid in 1919 in error of law, subsequently refunded, are not deductible as losses in the year paid. (*Inland Products Co.* v. *David H. Blair, commissioner.* U. S. circuit court of appeals, fourth circuit.)

Amounts representing 25% of the net income received from two partnerships and a corporation by a father and credited on his books to each of his sons in addition to salaries paid pursuant to an agreement entered into in consideration of their services and efforts, to be held in trust until such son married with his father's approval or arrived at the age of 35 years, are deductible as additional compensation. (*Louis Cohen* v. *Commissioner.* U. S. circuit court of appeals, fourth circuit.)

An abstract company was not entitled to personal-service classification for 1919, 1920 and 1921, where all the principal stockholders were not regularly engaged in the active conduct of the business and capital was a material income-producing factor. (*St. Paul Abstract Co.* v. *Commissioner.* U. S. circuit court of appeals, eighth circuit.)

The taxpayer may not recover in a suit for recovery of taxes on amount of tax based on a ground not stated in the claim for refund, a claim for refund without specifying the grounds upon which the claim is based being insufficient, and a statement in the brief for the government that one of the issues of fact was whether the taxpayer was entitled to the additional deduction claimed, in view of the general denial in the pleadings of the taxpayer's allegations in its declaration, not constituting a waiver of compliance with the statute and the regulations.

The cash value of tangible assets in excess of the par of the stock issued therefor should be included in invested capital for 1917 as paid-in surplus where acquired in a reorganization of a company effected through the acquisition by a reorganization committee of practically all the bonds and stock of the old corporation for which the new corporation issued all its stock to the committee which was distributed to bondholders and shareholders and the purchase of the assets of the old corporation at a foreclosure sale by the surrender of the bonds of the old corporation. (*Arizona Commercial Mining Co.* v. *A. J. Casey, collector.* District court of the U. S., district of Massachusetts.)

A month-to-month tenant may not deduct the total cost of permanent improvements made on leased property to adapt it to its own use in the year made, where the tenancy extended for a period substantially beyond the taxable year in which the improvements were made, but may deduct reasonable depreciation over the useful life of the improvements. (*The George H. Bowman Co.* v. *Commissioner.* Court of appeals of the District of Columbia.)

The filing of a tentative return on form 1031 T for the taxable year 1918 is sufficient to start the running of a statutory period of limitation on assessment and collection, such return amounting to more than an agreement for an extension of time since it was effective as a return for certain purposes under the statute. (*Brandon Corporation* v. *J. F. Jones, collector.* U. S. district court, eastern district of South Carolina.)

Payments by a corporation in 1920 to 1922 equal to 12½% of the net profitsfor such years pursuant to a contractual obligation entered into in 1905, in which year the corporation acquired the business of the payees in exchange for stock and agreed to make such payments during the existence of the corporation, are deductible as ordinary and necessary business expenses. (*George LaMonte & Son* v. *Commissioner.* U. S. circuit court of appeals, second circuit.)

A taxpayer in the business of taking long leases on property and subletting is not entitled under sec. 214 (a) (8), act of 1918, to deduct an allowance for depreciation on buildings under ninety-nine-year leases renewable forever requiring the lessee to keep the buildings up to their present condition. (*Harry H. Weiss, collector,* v. *J. Harry Wiener; C. F. Routzahn, collector,* v. *J. Harry Wiener.* Supreme court of the United States.)

A claim for refund was held not sufficient to support an action for recovery of taxes. (*Phoenix Glass Co.* v. *U. S. of America.* District court of the U. S., western district of Penna.)

Interest on a refund of 1919 taxes allowed by the commissioner in 1925, improperly withheld because offset against an amount claimed by the United States as due for supplies sold the taxpayer which claim was abandoned after the United States had instituted proceedings to recover the balance of the claim over the amount of the refund, was allowed from the date of the refund. In-

terest liability attaches to offsets made by the general accounting office just as it formerly did to those made by the treasury department. (*U. S. of America* v. *LaGrange Grocery Co.* U. S. district court, northern district of Georgia.)

The gross estate of a decedent dying in 1922 should include his contribution to a trust created in 1920 by the decedent and his wife providing for the payment of the income of the trust to his wife for life and upon her death of the whole of the trust property to the decedent, if living, or, if not living, to his heirs at law, where the settlers reserved the right to withdraw the whole or any part of the securities deposited by him or her under the terms of the instrument. (*William J. Dean, as administrator with the will annexed of the estate of William B. Dean, deceased,* v. *Willcuts, collector.* U. S. district court, third division, district of Minnesota.)

An importer who added to inventory the amount of customs duties paid during the taxable years 1919 to 1924 which was not applicable to goods sold during the year, thus adding the duties paid to the cost of goods sold, may not later file amended returns in order to deduct from gross income all duties paid during the year, either method being allowed under the applicable regulations and good accounting practice, and the provision of sec. 234 (a) (3), acts of 1918 and 1921 that taxes paid or accrued during the taxable year "shall be allowed as deductions" not being mandatory. (*Lebolt & Co.* v. *United States.* Court of claims of the U. S.)

Accrued interest on instalment-sales contracts not due and payable until after the purchase price was paid in full, and not paid within the taxable year, may not be included in invested capital of a taxpayer keeping books on the accrual basis except as to such interest which it consistently set up on its books as earned and returned as income in the year paid. (*Schmoller & Mueller Piano Co.* v. *United States.* Court of claims of the U. S.)

Students Department

H. P. BAUMANN, *Editor*

PROBLEM FROM ILLINOIS EXAMINATION

Problem:

The Hot Dog Blast Furnace Company, which has been in operation for a number of years, is desirous of putting out an issue of $4,000,000 6% first-mortgage bonds to retire an old bond issue and partially defray the cost of an entire new coke oven plant. Bankers agree to underwrite the issue at a discount of 5 per cent., and at their request you are employed to audit the books and prepare for publication a certified balance-sheet of the company as of September 30, 1928, showing thereon the cost of the new coke oven plant. You are to assume for the purposes of your balance-sheet that the new bond issue has been taken up by the underwriters as of that date and that the funds thus made available have been used to retire the old bond issue at 102 and to pay for, in part, the cost of the new coke oven plant, although these transactions will not actually take place until early in 1929. The company is to issue additional stock to the public at par ($50) to provide additional funds needed to complete the ovens and to reimburse the company for payments already made to contractors. You are instructed to embody in your certificate a statement of net earnings for each of the last six fiscal operating periods.

You find the company's trial balance as of September 30, 1928, as shown below. The retirement of the old bonds and the issue of the new bonds have not, of course, been given effect to, and no book entries have been set up to record contracts totaling $4,500,000 for the erection of a new coke oven plant. Construction work on these contracts had been begun during 1928.

HOT DOG BLAST FURNACE COMPANY
Trial balance, September 30, 1928

	Dr.	Cr.
Blast furnace, railway tracks, power plants, etc.	$1,800,000.00	
Coke ovens	1,500,000.00	
Real estate	325,000.00	
New coke ovens (payment on account to contractor)	500,000.00	
Reserve for depreciation—blast furnace, railway tracks, power plant, etc.		$ 520,000.00
Reserve for depreciation—coke ovens		1,010,000.00
Cash in bank and on hand	125,000.00	
Accounts receivable	580,000.00	
Notes receivable	105,000.00	
Hot Dog Blast Furnace Company bonds in treasury	250,000.00	
Accrued interest, treasury bonds	8,750.00	
Inventories, September 30, 1928, at cost	605,000.00	
Insurance paid in advance	5,000.00	
Unamortized bond discount and expense	30,000.00	
Accounts payable		334,000.00
Reserve for local taxes		31,000.00
Reserve for federal income taxes: 1927		10,328.75
1928		51,671.25
Reserve for bond interest		35,000.00
Reserve for contingencies (created December 31, 1926)		125,000.00
First-mortgage 7% gold bonds		1,000,000.00
Capital stock (authorized 60,000 shares at $50; outstanding, 32,000 shares)		1,600,000.00
Surplus		1,116,750.00
	$5,833,750.00	$5,833,750.00

An analysis of the surplus account for the six preceding fiscal periods, as disclosed by the books, is as follows:

Hot Dog Blast Furnace Company
Analysis of surplus

Balance, May 1, 1923		$ 679,791.25
May 15, 1923, cost of relining blast furnace and coke ovens during March and April, 1923, in excess of accumulated reserves at April 30, 1923	$ 70,000.00	
April 30, 1924, net profit for year		206,000.00
May 15, 1924, dividend	190,000.00	
April 30, 1925, net profit for year		272,000.00
May 15, 1925, dividend	240,000.00	
April 30, 1926, net profit for year		195,000.00
May 15, 1926, dividend	175,000.00	
October 15, 1926, additional federal income tax for year ended April 30, 1924	4,320.00	
December 31, 1926, net profit, eight months		263,000.00
January 15, 1927, dividend	200,000.00	
December 31, 1927, net profit for year		287,000.00
January 15, 1928, dividend	200,000.00	
April 10, 1928, additional federal income tax for year ended April 30, 1925	2,300.00	
September 30, 1928, net profit, nine months		308,328.75
September 30, 1928, addition to reserves for depreciation necessary to make total reserved from May 1, 1923, to September 30, 1928, equal to 4% per annum	24,000.00	
September 30, 1928, cost of relining blast furnace (work done August and September, 1927) in excess of accumulated reserve at September 30, 1928	78,750.00	
September 30, 1928, reserve for relining coke ovens transferred to surplus as it will not be needed in view of new construction about to be made		90,000.00
Balance, September 30, 1928	1,116,750.00	
	$2,301,120.00	$2,301,120.00

The following conditions are also disclosed by your examination:

(a) You find that the plant values shown by the books are at cost and that the provisions for depreciation during the last six fiscal operating periods are as shown below. You find that an average rate of 4 per cent. per annum on the book cost of the entire plant at the close of each fiscal period is a reasonable basis for depreciation; and this rate and method have been acquiesced in by the treasury department for income-tax purposes.

Period ended	Plant value	Depreciation provided on books
April 30, 1924	$2,700,000.00	$100,000.00
April 30, 1925	2,900,000.00	100,000.00
April 30, 1926	3,000,000.00	120,000.00
December 31, 1926	3,000,000.00	80,000.00
December 31, 1927	3,100,000.00	124,000.00
September 30, 1928	3,300,000.00	123,000.00*

* (Including surplus adjustment of $24,000.)

(b) A report of the Wisconsin Appraisal Company made as of September 30, 1928, as a preliminary to this refinancing, is presented to you which states

that the sound value of the company's plant, including the real estate, is in excess of the cost, less depreciation reserves, as shown by the books of account to the extent of $900,000 exclusive of the old coke ovens, which the appraisers do not undertake to value.

(c) The contractors who are erecting the new coke ovens have agreed to take over the old coke ovens and to utilize as much of the material contained therein as possible in the erection of the new ovens, allowing therefor a salvage value of $400,000 which is to be applied in reduction of the contract price for the new ovens. The process of scrapping may be regarded as complete at September 30, 1928.

(d) Blast-furnace relining reserve has been provided on the basis of 25 cents per ton of iron produced. Coke-oven relining reserve has been provided on the basis of 10 cents per ton of coal coked. You are to assume that this provision is scientifically correct and is based on the company's past experience. Production during the past six periods has been as follows:

Period ended	Iron produced	Coal coked
April 30, 1924	98,000 tons	176,000 tons
April 30, 1925	110,000 tons	175,000 tons
April 30, 1926	83,000 tons	149,000 tons
December 31, 1926	78,000 tons	110,000 tons
December 31, 1927	117,000 tons	160,000 tons
September 30, 1928	39,000 tons	130,000 tons
	525,000 tons	900,000 tons

(e) Your examination discloses that the market value of the inventory at September 30, 1928, was $75,000 in excess of its cost owing to a recent heavy advance in coal prices.

(f) You are satisfied that the only contingent liability of the company is a suit for $5,000 breach of contract alleged to have occurred in 1928.

(g) The company's income tax has been paid and its returns have been reviewed and final adjustments made through the year ended December 31, 1927. Deductions for relining costs are taken on the income-tax returns when the expenditure is actually made and not as the reserve for relining is set up. The 1928 tax reserve, therefore, calls for adjustment by you.

Prepare the balance-sheet and certificate which, under the condition as outlined, you would furnish to the banker. Write off unamortized discount and expense of old bond issue and the premium paid on the retirement of the issue as direct surplus charges at September 30, 1928.

Solution:

The following entries are in explanation of adjustments in the working papers on page 462:

Explanatory adjusting entries

(1)

New coke ovens (payment on account to contractor)	$ 400,000.00	
Reserve for depreciation—coke ovens	1,010,000.00	
Surplus	90,000.00	
Coke ovens		$1,500,000.00

To write off old coke ovens and to record the book loss and allowance for scrap value of the old ovens.

Hot Dog Blast Furnace Company

Working papers, trial balance, September 30, 1928

	Trial balance September 30, 1928 Dr.	Trial balance September 30, 1928 Cr.	Adjustments Dr.	Adjustments Cr.	Adjusted trial balance September 30, 1928 Dr.	Adjusted trial balance September 30, 1928 Cr.
Blast furnace, railway tracks, power plants, etc.	$1,800,000.00				$1,800,000.00	
Coke ovens	1,500,000.00			(1) $ 1,500,000.00		
Real estate	325,000.00				325,000.00	
New coke ovens (payment on account to contractor)	500,000.00		(1) $ 400,000.00	(5) 900,000.00		
Reserve for depreciation—blast furnace, railway tracks, power plant, etc.		$ 520,000.00				$ 520,000.00
Reserve for depreciation—coke ovens		1,010,000.00	(1) 1,010,000.00			
Cash in bank and on hand	125,000.00		(2) 3,800,000.00	(3) 791,250.00		
			(6) 1,100,000.00	(5) 3,008,750.00		
				(8) 591,250.00	633,750.00	
Accounts receivable	580,000.00				580,000.00	
Notes receivable	105,000.00				105,000.00	
Hot Dog Blast Furnace Company bonds in treasury	250,000.00			(3) 250,000.00		
Accrued interest, treasury bonds	8,750.00			(3) 8,750.00		
Inventories, September 30, 1928, at cost	605,000.00				605,000.00	
Insurance paid in advance	5,000.00				5,000.00	
Unamortized bond discount and expense	30,000.00		(2) 200,000.00	(3) 30,000.00	200,000.00	
Accounts payable		334,000.00				334,000.00
Reserve for local taxes		31,000.00				31,000.00
Reserve for federal income taxes: 1927		10,328.75				10,328.75
1928		51,671.25	(8) 47,141.25			4,530.00
Reserve for bond interest		35,000.00	(3) 35,000.00			
Reserve for contingencies (created December 31, 1926)		125,000.00				125,000.00
First-mortgage 7% gold bonds		1,000,000.00	(3) 1,000,000.00			
Capital stock (authorized 60,000 shares at $50: outstanding 32,000 shares)		1,600,000.00		(6) 1,100,000.00		2,700,000.00
Surplus		1,116,750.00	(1) 90,000.00	(8) 47,141.25		
			(3) 15,000.00			
			(3) 30,000.00			
			(9) 34,510.97			994,380.28
	$5,833,750.00	$5,833,750.00				
First-mortgage 6% bonds				(2) 4,000,000.00		4,000,000.00
New coke oven plant			(4) 4,500,000.00		4,500,000.00	
Contracts payable			(5) 3,908,750.00	(4) 4,500,000.00		
			(8) 591,250.00			
Reserve for relining blast furnace				(9) 34,510.97		34,510.97
			$16,761,652.22	$16,761,652.22	$8,753,750.00	$8,753,750.00

(2)

Unamortized bond discount and expense	$ 200,000.00	
Cash in bank and on hand	3,800,000.00	
First mortgage 6% bonds		$4,000,000.00
To record new issue of bonds at a discount of 5%.		

(3)

First mortgage 7% bonds	1,000,000.00	
Reserve for bond interest	35,000.00	
Surplus (bond premium)	15,000.00	
Surplus (unamortized bond discount and expense)	30,000.00	
Unamortized bond discount and expense		30,000.00
Hot Dog Blast Furnace Company—treasury bonds		250,000.00
Accrued interest, treasury bonds		8,750.00
Cash in bank and on hand		791,250.00
To record the retirement of the old bond issue at 102.		

(4)

New coke oven plant	4,500,000.00	
Contracts payable		4,500,000.00
To record the contracts for the new coke oven plant and the liability thereon.		

(5)

Contracts payable	3,908,750.00	
New coke ovens (payment on account to contractor)		900,000.00
Cash		3,008,750.00
To transfer the payments on account and to record the payment of the remainder of the cash proceeds of the new financing.		

(6)

Cash	1,100,000.00	
Capital stock		1,100,000.00
To record the sale of 22,000 shares (par $50) of capital stock at par to provide additional funds needed to complete the ovens and to reimburse the company for payments already made to the contractors.		

Cost	$4,500,000.00
Payment and scrap allowance	3,908,750.00
Balance due	$ 591,250.00
Amount of payment made	500,000.00
Total	$1,091,250.00

(7)

Contracts payable	$591,250.00	
Cash		$591,250.00
To record payment of balance due contractors.		

(8)

Reserve for income taxes	47,141.25	
Surplus		47,141.25
To adjust provision for federal income taxes.		

(9)

Surplus	34,510.97	
Reserve for relining blast furnace		34,510.97
To record accumulated reserve for relining blast furnace.		

The cost of relining the blast furnace may be determined as follows:

Accumulated reserve at September 30, 1928 (525,000 tons at 25 cents a ton)	$131,250.00
Excess of accumulated reserve at September 30, 1928, charged to surplus account	78,750.00
Total	$210,000.00

This amount represents the cost of relining the blast furnace which work was done during August and September, 1927, and against which a reserve was built up over the period beginning May 1, 1923, and ending, presumably, July 31, 1927. On the assumption that no iron was produced during the months of August and September, 1927, and that the production of 117,000 tons was distributed equally over the ten working months of that year it will be found that cost of relining was $97,275 more than the accumulated reserve at July 31, 1927. This underprovision should be distributed over the periods beginning May 1, 1923, as shown in the following schedule, and the profits adjusted accordingly. (See working papers on next page).

Period ended	Tons produced	Reserved at 25 cents a ton	Actual cost 46.57+ cents a ton	Under-provision
April 30, 1924	98,000 tons	$ 24,500.00	$ 45,642.06	$21,142.06
April 30, 1925	110,000 tons	27,500.00	51,230.87	23,730.87
April 30, 1926	83,000 tons	20,750.00	38,656.02	17,906.02
December 31, 1926	78,000 tons	19,500.00	36,327.34	16,827.34
July 31, 1927 (11,700 tons × 7 mos.)	81,900 tons	20,475.00	38,143.71	17,668.71
Total to July 31, 1927	450,900 tons	$112,725.00	$210,000.00	$97,275.00

The reserve for relining the blast furnace accumulated since the work of relining was completed (presumably October 1, 1927) should be adjusted to the

HOT DOG BLAST FURNACE COMPANY

Working papers to correct profits

Period ended

	April 30, 1924		April 30, 1925		April 30, 1926		December 31, 1926		December 31, 1927		September 30, 1928	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Profit per books..		$206,000		$272,000		$195,000		$263,000		$287,000		$308,328.75
Additional depreciation charged to surplus (see below)........	$ 8,000.00		$ 16,000.00									
Additional federal income taxes ..	4,320.00		2,300.00									
Reserve for contingencies.....								125,000				
Additional charges for relining blast furnace.......	21,142.06		23,730.87		$ 17,906.02		$ 16,827.34		$ 25,241.01		$ 8,413.67	
Overprovision—federal income taxes.........												47,141.25
Corrected net profit.........	172,537.94		229,969.13		177,093.98		371,172.66		261,758.99		347,056.33	
Totals........	$206,000.00	$206,000	$272,000.00	$272,000	$195,000.00	$195,000	$388,000.00	$388,000	$287,000.00	$287,000	$355,470.00	$355,470.00

basis of 46.57 cents per ton (see adjusting entry No. 9 which is supported by the following):

Period	Tons produced	Reserved at 25 cents a ton	Adjusted cost 46.57+ cents a ton	Under-provision
October 1, 1927, to December 31, 1927 (11,700 tons × 3 mos.)	35,100 tons	$ 8,775.00	$16,347.30	$ 7,572.30
January 1, 1928, to September 30, 1928.....	39,000 tons	9,750.00	18,163.67	8,413.67
Totals.................	74,100 tons	$18,525.00	$34,510.97	$15,985.97

Computation of depreciation by periods

Period ended	Plant value	Deprecia-tion at 4% per annum	Deprecia-tion pro-vided on books	Excess or deficiency*
April 30, 1924	$2,700,000.00	$108,000.00	$100,000.00	$ 8,000.00*
April 30, 1925	2,900,000.00	116,000.00	100,000.00	16,000.00*
April 30, 1926	3,000,000.00	120,000.00	120,000.00	
December 31, 1926...	3,000,000.00	80,000.00	80,000.00	
December 31, 1927...	3,100,000.00	124,000.00	124,000.00	
September 30, 1928 ..	3,300,000.00	99,000.00	123,000.00	24,000.00
		$647,000.00	$647,000.00	

Computation of adjustment of federal income tax (1928)

Profit per books.............................		$308,328.75
Add:		
Reserve for relining blast furnace.............	$ 9,750.00	
Reserve for relining coke ovens..............	13,000.00	
		22,750.00
Reserve for income tax.....................		51,671.25
Total taxable income (upon which reserve for taxes was computed at rate of 13½%)....		$382,750.00
Deduct:		
Actual cost of relining blast furnace	$210,000.00	
Loss on coke ovens retired...................	90,000.00	
Unamortized bond discount and expense	30,000.00	
Premium on bonds retired...................	15,000.00	
		345,000.00
Taxable net income.........................		$37,750.00

Reserve for income taxes—1928	$51,671.25
Income tax (12% of $37,750.00)	4,530.00
Overprovision (see adjusting entry No. 8)	$47,141.25

HOT DOG BLAST FURNACE COMPANY

Statement of surplus account for the period, May 1, 1923, to September 30, 1928

Balance, May 1, 1923		$ 679,791.25
Deduct:		
Cost of relining blast furnace and coke ovens in excess of reserve at April 30, 1923		70,000.00
Adjusted balance, May 1, 1923		$ 609,791.25
Add:		
Adjusted profits—for periods ended—		
April 30, 1924	$ 172,537.94	
April 30, 1925	229,969.13	
April 30, 1926	177,093.98	
December 31, 1926	371,172.66	
December 31, 1927	261,758.99	
September 30, 1928	347,056.33	1,559,589.03
Total		$2,169,380.28
Deduct:		
Dividends paid	$1,005,000.00	
Discount and premium on bonds	45,000.00	
Loss on old coke ovens	90,000.00	
Reserve for contingencies	125,000.00	1,265,000.00
		$ 904,380.28
Add:		
Excess of reserve for relining coke ovens (old)		90,000.00
Adjusted balance, September 30, 1928		$ 994,380.28

HOT DOG BLAST FURNACE COMPANY

Balance-sheet, September 30, 1928

After giving effect to the cost of the new coke oven plant and the retirement of 7% bonds by issue of new 6% first-mortgage bonds and the sale of 22,000 shares of capital stock.

Assets

Current assets:	
Cash in bank and on hand	$ 633,750.00
Accounts receivable	580,000.00

Notes receivable			$105,000.00	
Inventories at cost (market value $680,000)			605,000.00	
				$1,923,750.00
Unexpired insurance				5,000.00
Unamortized bond discount and expense				200,000.00
Fixed assets (see note):				
Particulars	Cost	Reserve for depreciation	Book value	
Coke ovens (under construction)	$4,500,000.00		$4,500,000.00	
Blast furnace, railway tracks, power plant, etc.	1,800,000.00	$520,000.00	1,280,000.00	
Land	325,000.00		325,000.00	
	$6,625,000.00	$520,000.00	$6,105,000.00	6,105,000.00
				$8,233,750.00

Liabilities and net worth

Current liabilities:			
Accounts payable		$334,000.00	
Reserve for local taxes		31,000.00	
Reserve for federal income taxes:			
1927	$10,328.75		
1928	4,530.00	14,858.75	
			$ 379,858.75
Contingent liability on suit for breach of contract	$5,000.00		
First-mortgage 6% bonds			4,000,000.00
Reserve for relining blast furnace			34,510.97
Net worth:			
Capital stock—			
Authorized 60,000 shares of a par value of $50.00 each			
Outstanding 54,000 shares		$2,700,000.00	
Surplus		994,380.28	
Reserve for contingencies		125,000.00	
			3,819,380.28
			$8,233,750.00

NOTE.—The sound value of the company's fixed assets, exclusive of coke ovens, as shown by the report of the Wisconsin Appraisal Company was $2,505,000 at September 30, 1928.

We have examined the accounts of the Hot Dog Blast Furnace Company for the period from May 1, 1923, to September 30, 1928; the corporate records

and agreements relating to the erection of a new coke oven plant, the retirement of the 7% first-mortgage bonds ($750,000 outstanding), the new issue of 6% first-mortgage bonds ($4,000,000), and the sale of 22,000 shares of capital stock at par ($50.00).

We certify that, in our opinion, the above pro-forma balance-sheet fairly presents the financial condition of the Hot Dog Blast Furnace Company as at September 30, 1928, had the coke oven plant been erected and the financial transactions been completed at that date.

We further certify that, in our opinion, the amounts shown below fairly present the net earnings of the company (after providing for federal income taxes) for each of the past fiscal operating periods ended:

April 30, 1924	$ 172,537.94
April 30, 1925	229,969.13
April 30, 1926	177,093.98
December 31, 1926	371,172.66
December 31, 1927	261,758.99
September 30, 1928	347,056.33
Total	$1,559,589.03

Book Reviews

FEDERAL TAX PRACTICE, by ROBERT H. MONTGOMERY. *The Ronald Press Co.*, New York, 757 pages.

With the publication of *Federal Tax Practice* Mr. Montgomery adds materially to his valuable contributions to the practical aspects of federal income taxation. His earlier publications, dealing with income-tax procedure under various income-tax laws, have been perhaps the most widely used of the textbooks on the subject. These books have always had a strong appeal, particularly to those whose interest in tax problems was of the practical variety, because he has consistently dealt with the subject with directness and simplicity. The present book is an excellent example of Mr. Montgomery's ability to deal with a complicated and often irritating situation in a clear, simple and orderly manner, readily understandable by the merest tyro.

In his preface Mr. Montgomery disclaims any intention to attempt the education of the layman and it is all the more to his credit that he has made the book simple, even though, as he states, it is primarily intended for the consumption of lawyers and professional accountants. Heaven knows, most of us, however expert we may believe ourselves to be, frequently end up in a maze when attempting to discern for ourselves the meaning of many of the provisions of the law, the regulations and the rulings of the bureau.

The book is divided into three main parts, as follows: (1) procedure in the treasury; (2) procedure in the board of tax appeals; (3) procedure in the federal courts.

Accountants will be primarily interested in part I because it is in the practice before the treasury that problems of a purely accounting nature can be ironed out, and in that practice the accountant may properly occupy a leading rôle. While their assistance may be invaluable to counsel in proceedings before the board of tax appeals and before the courts it is the opinion of the reviewer that accountants should not themselves attempt to represent their clients before the board. Before the courts they may not.

Mr. Montgomery in his introductory chapter suggests that accountants should practise before the board only if they have become fully acquainted with the rules of evidence and procedure, but even if so fortified he points out that they lack the training and experience necessary to protect the interests of their clients in a proceeding which has become as technical as is a hearing before the board. Without such training and experience he says they will not "be able to apply their knowledge from memory, on their feet, and without special notice regarding the legal questions which will arise."

It is worthy of note that part I, dealing with procedure in the treasury, occupies some 210 pages; part II, dealing with the U. S. board of tax appeals, 168 pages, and part III, dealing with the federal courts, only 51 pages.

In addition to the introductory chapter there is, preceding part I, a chapter on statutory construction.

In reading part I the impression is gained that Mr. Montgomery has come to the conclusion that, while there may still be room for improvement, the treasury on the whole has done a good job in the administration of the tax laws. In various places he is complimentary. On page 22, for instance, he says of the special advisory committee, "It is to be complimented on being the first body in

the organizaton of the treasury department which has whole-heartedly and successfully coöperated with taxpayers in reaching a solution of problems which theretofore had been thought to require the attention of the courts or of the board of tax appeals". He points out that there is still "a tendency . . . toward too much review", and says, "Too many reviews, like too many medicines, are inclined to kill and not cure". Most tax practitioners will heartily agree with this good-tempered criticism.

Mr. Montgomery stresses the importance of laying the foundations, in the earlier proceedings, to comply fully with the procedural necessities at present in vogue in the trying of cases before a court. Why this should be essential will always be a mystery to the layman and perhaps this necessity is partly, if not primarily, at the back of the seeming stupidity of court procedure. One gathers from the utterances of President Hoover that his proposal to cause a review of court practices and procedure in general had its origin in just such a necessity. Why in the name of all that is high does the appellate court in New York state refuse to review rulings on evidence where the lawyer has used the word "objection" in the lower court when the procedure in this state requires the use of the sacred word "exception" in addition? Mr. Montgomery, of course, is dealing with procedure as it exists, but the very fact that he recommends that, from the ground roots up, tax cases, no matter how simple, should be tried not only with the object of winning them, but of laying the necessary foundation for a court trial (that may never take place) in itself shows a justification for President Hoover's recommendation.

In happier vein Mr. Montgomery mentions the existence of a disposition on the part of the treasury to meet taxpayers half way in the compromise of contested cases. He is doubtless familiar with the fact that this spirit has grown up in the last year or so under the inspiration and direction of Assistant Secretary of the Treasury Henry Herrick Bond. Most practitioners during this period must have felt, consciously or unconsciously, the gradual improvement in attitude on the part of bureau officers, extending even to general counsel's office. Since Mr. Montgomery's book was written the review division of that office has been remodeled by Mr. Bond and is now making a real effort to settle cases by compromise. What Mr. Montgomery says about the special advisory committee is equally true of the review division of general counsel's office as it now operates.

Federal Tax Practice is a welcome addition to income-tax literature and will doubtless be as widely read by tax practitioners as Mr. Montgomery's several editions of *Income-tax Procedure.*

In the preparation of *Federal Tax Practice* Mr. Montgomery acknowledges the assistance of J. Marvin Haynes, Roswell F. Magill and James O. Wynn.

DONALD ARTHUR.

LEGAL ACCOUNTING AND COURT AUDITING, by HERBERT L. DAVIS. *Vernon Law Book Co.*, Kansas City. 796 pages.

The brief title on the cover of *Legal Accounting and Court Auditing* is amplified on the inside title page, indicating its contents and intended scope to be a treatise on

"Legal accounting and court auditing—federal and state practice in law, equity and kindred proceedings—respecting the duties of masters in chancery,

court auditors, referees and fiduciaries—together with analyses of cases involving the application of principles respecting accounting, patent infringement suits and legal precedents pertaining to trust estates, proceedings in partition, contracts, banks and banking, by Herbert L. Davis, L.L.M., former referee and court auditor, supreme court of the District of Columbia, member of the bar of the supreme court of the United States."

If thereto be added, by way of perhaps unnecessary further qualifications of the author, "instructor in legal accounting and court auditing, National University Law School, Washington, D. C.," the first impression one gains is that this book covers a special field of accounting by an experienced and trustworthy authority, and when one has become familiar with its contents and their arrangement, this first impression will broaden to a conviction that this important field and its various branches have been completely and instructively covered and that the volume is well deserving of a readily accessible place in the office, library and file records as a much needed, compact source of information, guide and reference.

The descriptive title page presents the broad scope of the volume. Of its contents some 590 pages are devoted to twenty-one chapters classified under various legal subjects, in relation to which accounting requirements may and do arise. An appendix of some 130 pages contains the revised rules of the supreme court of the United States (effective July 1, 1928) and rules of practice for the courts of equity of the United States, and these are followed by a subject index and a table of cases cited. The various chapters are devoted to the broader legal subjects, such as law of contracts; patent causes; constitutional law and its relation to the work of court auditors, masters and referees; provability of claims; hearings and procedure; testimony and evidence, trust estates; fees, commissions and allowances; corporate and individual fiduciaries; debts and legacies, and numerous others. These broader subject matters are again subdivided and grouped into more specific classifications or sub-sections, all preceded by a descriptive table of contents.

A further subject index then points to the treatment of such special subjects as accountants; accounting suits; bankruptcy proceedings; distribution of funds under accounting; fiduciaries; legal accounting; accounts stated; realization and liquidation accounts, etc., etc., as they respectively relate or apply to the broader covering sections on the laws, practice and procedure. This very comprehensive detailed arrangement proves decidedly practical and helpful in facilitating convenient and ready reference.

The chapters are interspersed with a number of illustrative reports, statements and schedules, as submitted in actual cases by auditors or referees, and accepted and approved by the court. Of interest and importance will be found the cases and the decisions rendered therein, cited by the author for the avowed purpose of making readily accessible in such instances the leading precedents and guiding cases of the numerous jurisdictions. The cases relate variously to principles and procedures in the numerous branches of legal accounting; to the guiding principles in the interpretation of written instruments; to approved services by professional accountants employed under court orders; to the duties, limitations and restrictions of fiduciaries, etc., etc. Under the latter subject, as one of various instances, the report of the Hon. Jas. A. O'Gorman, referee in the action of *Gould* v. *Gould*, for the judicial settlement of the accounts of the executors and trustees of the Jay Gould estate, is cited in full. The sections devoted,

among others, to the administration of trust estates, differentiation between investments and speculation, the commingling of trust funds constituting a criminal offense in New York state, and various other features of the obligations and accountability of such fiduciaries constitute subjects of vital and absorbing interest.

Following largely the practical case method, the book thus covers along lines of actual experience the practice and procedure under which matters of accounting arise and are referred by the courts to referees, masters, auditors or similar appointees, and the rules or principles of law and precedent which are to guide and control them in their duties. The author offers wise counsel in matters affecting both lawyers and professional accountants. He advises a clear division of responsibilities and duties, with due regard to questions of law and fact for the purpose of effective coördination and complete understanding and coöperation. There are also various helpful and interesting sections on fees and compensation, and the value and measures therefor of professional services.

In its initial paragraphs the book informs us that it is not intended to cover instruction in commercial accounting, but that it is a comprehensive exploration in a heretofore practically unsurveyed field and that it is an endeavor, without sacrificing clarity to set forth tersely definite statements of policy, procedure and method to be pursued, with a minimum of theory.

It is pleasant to note in this volume that the author is a persuasive and convincing exponent of the character, scope and value of the services of accountants and of the gratifying increase in the value placed on their services by clients. He refers to the trend on the part of the courts to select qualified accountants as receivers, assignees and trustees, especially in the active management of going businesses, and staunchly asserts that this admirable plan has worked to the decided advantage of trust estates. His book is thus in perfect accord with his sentiments, in that it constitutes a valuable and instructive contribution towards increased proficiency in the science and practice of legal accounting and court auditing. As such it is deserving of a warm and appreciative welcome.

W. F. WEISS.

HOW TO ANALYZE COSTS, by COLEMAN L. MAZE and JOHN G. GLOVER. *The Ronald Press Co.*, New York, 1929. 402 pages.

The purpose of *How to Analyze Costs* is to present "a detailed analysis of the major elements of manufacturing, selling and administrative costs and set forth a procedure for determining the causes of their variation from the figures of previous periods or from predetermined estimates." It is designed primarily as a text for collegiate schools of business.

The first chapter presents the subject of standards, to which constant reference must be made in later pages of the book, inasmuch as standards serve as criteria for comparison with analyzed costs.

Chapters two to seven, inclusive, set forth a general description of ideas and facts with which a reader should be at least superficially familiar in order to understand fully the cost analyses that follow.

Beginning with the eighth chapter and continuing through part of the eighteenth there is a description of all the kinds of factory costs customarily shown by the accounting system, the description of each such cost being fol-

lowed by detailed analysis of the causes for variations in that cost and by exposition of the ways to ascertain such causes. The first of these chapters, the eighth, describes the analysis of direct material costs; the next, analysis of direct labor costs, and the others, overhead costs.

The latter part of the eighteenth chapter and the nineteenth and twentieth chapters discuss analysis of selling and administrative costs. Chapters twenty-one and twenty-two describe standard-cost systems; chapter twenty-three, the budget as a set of standards for current costs; and the final three chapters, ways of making cost information more understandable and more useful to the executives and accountants who can profit by it.

The general method of ascertaining the reasons for variations in costs, as presented in this book, is one that common sense would prescribe. A typical illustration of this declaration is to be seen in the enumeration (p. 106) of twenty causes of increased direct-labor costs, among such causes being the following: wage increases, poor supervision, idle time, defective equipment, labor turnover, and others equally obvious to any one able to visualize ordinary labor conditions in a factory. The value of the book lies, however, in systematic, comprehensive classification and discussion of the causes for increases or decreases in almost all the kinds of costs likely to be found in most concerns.

The descriptions and discussions are concise—perhaps, in some cases, too concise. The description of line, functional and staff plans of organization in the first chapter seems, for example, too brief to do anything but confuse a reader, perhaps the representative business-man type, not already familiar with such technical nomenclature. Writers of scientific treatises are, of course, always faced with the difficult problem of properly apportioning space to incidental explanation not closely related to the main thesis.

Some statements made presumably for the sake of brevity may give a student false ideas about the simplicity of really complex conditions. The authors declare, for instance (p. 225), that the amount in a depreciation reserve should equal the cost of a fixed depreciable asset when the asset is retired from service, so that funds for replacement of that asset will be available. Unfortunately, however, for the sake of verity in the accounting postulate that a dollar has always the same value and that, therefore, prices remain unchanged, the ability to replace a depreciated asset may bear only a haphazard relationship to the amount of funds reserved by a depreciation reserve that was built up by basing depreciation on original cost. That the authors subconsciously realize all this, of course, is shown by their subsequent assertion (p. 228) that future replacement cost "should be given some weight in setting rates of depreciation." Incidentally noticeable in this particular discussion is the cautious participation by the authors in a controversial matter (depreciation on original cost vs. depreciation on replacement cost). In most cases they wisely refrain from taking sides in unsettled accounting disputes—and this their subject permits them to do inasmuch as the purpose of the book is to analyze costs already incurred and not to set costs, such as depreciation.

Throughout the volume proper emphasis is placed upon the relative position of accounting in the organization and management of an enterprise. Recurrent reference is made to accounting as the tool of management and not as an end in itself. And emphasis is continually laid upon the necessity for con-

structive use of cost analyses after such information has been obtained and compiled for executive guidance.

The viewpoint is a practical yet scientific one. The statements are frank. The declarations are sound, if occasional allowance be made for exceptions to statements that the authors doubtless meant to be mere generalizations. The style is quite readable, although perhaps the occasional use of actual figures would have made the page after page of technical printed matter, account classifications and blank forms somewhat more interesting and more tangibly related to the actual accounting use for which the book is intended.

Authors can not, of course, please everybody, especially when no two opinions tend to agree in details. Nevertheless, the book seems well worth reading and keeping available for reference—a good job on a subject not comprehensively and systematically treated previously.

HENRY SWEENEY.

EXECUTIVES' BUSINESS LAW, by H. A. TOULMIN, JR. *D. Van Nostrand Co., Inc.*, New York. 786 pages.

It is pretty generally agreed among accountants that their functions and those of the lawyer are supplementary; that members of both professions should be consulted in situations which involve elements of both law and accounting, and that few practitioners are capable of being thoroughly proficient in both. However, because of the close relationship of law and accounting in many business affairs it is also commonly believed that the accountant and the lawyer each should know something of the other's subject—enough, at least, to recognize the necessity for the other's counsel in certain situations.

Executives' Business Law is a book which should be of value to accountants who wish such an acquaintance with legal matters. It emphatically disclaims any attempt to provide information which will make legal assistance dispensable, but it does profess to cover, in skeleton form, the whole field of American law affecting business. It is easily conceivable that regular reference to this book might keep a business man out of many troublesome situations.

It seems paradoxical to say that a book of 786 pages has the great merit of brevity, but the statement is perfectly true in this case. The chapter on consolidations and reorganizations, for instance, contains a little less than five pages of printed matter, but it nevertheless includes much information. The bulk of the book is caused by the breadth of the subject which it covers, not by any unnecessary discursiveness on the part of the author. The form of presentation, indeed, is hardly more than an outline, with brief, explanatory comments. Abundant sub-headings in bold type make it easy to find the particular topic on which enlightenment is desired.

Each new section is indicated by the tiny design of an acorn, which may be either an expression of botanical predilections on the part of the printer or a reminder to youthful readers that "parvis e glandibus quercus."

J. L. C.

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INDEX

PAGE

Accountability to Their Supporters, Benevolent Organizations and Their. Charles E. Mather.......... 419
Accountants' Certificates. Henry B. Fernald.......... 1
Accounts and Their Audit, Stock-brokerage. Anson Herrick.......... 93
Accounts of an Investment Trust. Herman E. Schreiber..........161, 253
American Institute of Accountants Examinations, May, 1929.......... 401
Appeals from Claim Rejections. Hugh C. Bickford.......... 184
Asset Valuation, No-par Stock and. Frederick H. Hurdman.......... 81
Audit, Requirements of a Balance-sheet. Charles B. Couchman.......... 20
Audit, Stock-brokerage Accounts and Their. Anson Herrick.......... 93

Balance-sheet Audit, Requirements of a. Charles B. Couchman.......... 20
Banks, Standard Financial-statement Form for. Emanuel Saxe.......... 37
Benevolent Organizations and Their Accountability to Their Supporters. Charles E. Mather.......... 419
Bookkeeping by Double Entry, Early History of. P. Kats..........203, 275
Book Reviews:
Accounting and Cost Finding for the Chemical Industries.......... 70
Accounting and Finance.......... 393
Analysis of Railroad Securities.......... 71
Auditing.......... 73
Auditors' Reports and Working Papers.......... 392
Corporation Profits.......... 389
Elementary Accounting.......... 395
Executives' Business Law.......... 475
Federal Income Taxation.......... 391
Federal Tax Practice.......... 470
How to Analyze Costs.......... 473
Income-tax Procedure, 1929.......... 390
Legal Accounting and Court Auditing.......... 471
Margins, Expenses and Profits in Retail Hardware Stores.......... 393
Trade Associations—The Legal Aspects.......... 72

Certificates, Accountants'. Henry B. Fernald.......... 1
Claim Rejections, Appeals from. Hugh C. Bickford.......... 184
Correspondence:
What Are Net Profits?.......... 234
Current Literature..........75, 156, 236, 317, 396, 476

Double Entry, Early History of Bookkeeping by. P. Kats..........203, 275

Early History of Bookkeeping by Double Entry. P. Kats..........203, 275
Economic and Historical Aspects of Taxation, Some. Charles W. Smith. 119

PAGE

Editorial:
Accountant Deserves a Desk, The ... 302
Accountant Is Different, The ... 127
Accountants and Credit Questionnaires ... 42
Accountant's Duty in Salvage Operations ... 298
Advisor in Bankruptcy, An ... 213
Another Chapter of the History ... 359
Arkansas Law and the Accountant, An ... 448
Arkansas Recognizes the Profession ... 362
Auditor's Responsibility to the Public ... 297
Background, The ... 356
Bankruptcies and Corruption ... 211
Banks, of Course, Are Good ... 212
But Accountants Would Be Better ... 212
But What of the Client? ... 216
Concerning Remote Contingencies ... 214
Dangerous Development of Corporation Laws ... 443
Evil Way May Be Avoided, The ... 217
Example to Other Jurisdictions, An ... 363
How the Text Was Published ... 358
How to Terminate an Engagement ... 214
Instructions for Verification of Financial Statements ... 355
Lawyer's Views on Contingent Fees, A ... 47
Let the Employer Beware ... 45
Menace of Fee-Splitting, The ... 131
Misuse of Accountant's Name ... 297
New Committee Appointed, A ... 360
Plural Prerogative, The ... 126
Principle of No-par-value Stock Is Sound ... 445
Professions are Urged to Advertise ... 131
Proper Audit Lacking, A ... 43
Protection for the Directors ... 444
Recent Changes Are Perilous ... 446
Relief for the Examiner ... 49
Report Is Written, The ... 361
Rules of Obligation ... 301
Rules of Prudence ... 301
Sin of Conservatism, The ... 133
Soliciting with a Vengeance ... 299
Some Evils Should Be Exposed ... 218
Someone Must Collect ... 50
State Boards Not Always Thorough ... 46
Statutory Audit, A? ... 134
Suspicion of Prejudice, The ... 48
There Should Be One Answer ... 216
This Golconda of the Professions ... 300
Verification of Inventories ... 128
What Are Net Profits? ... 44
What the Accountant May Do About It ... 447

PAGE
What the Instructions Include 361
When Answers Are Proper 43
Why the Original Text Was Written 357
Examination in Law, Institute. Spencer Gordon 373
Examinations, May, 1929, American Institute of Accountants 401

Financial-statement Form for Banks, Standard. Emanuel Saxe 37
Financial Statements, Verification of 321

Goodwill, Some Legal Aspects of. L. L. Briggs 429

Historical Aspects of Taxation, Some Economic and. Charles W. Smith. 119
History of Bookkeeping by Double Entry, Early. P. Kats 203, 275

Income-tax Department. Edited by Stephen G. Rusk. 140, 222, 306, 370, 456
Industrial Pensions and Wages. John Whitmore 174, 241
Institute Examination in Law. Spencer Gordon 373
Inventories, The Retail Method of. J. P. Friedman 106
Inventory, Organizing for. Robert Iglauer 192
Investment Trust, Accounts of an. Herman E. Schreiber 161, 253

Law, Institute Examination in. Spencer Gordon 373
Legal Aspects of Goodwill, Some. L. L. Briggs 429

No-par Stock and Asset Valuation. Frederick H. Hurdman 81

Organizations and Their Accountability to Their Supporters, Benevolent.
Charles E. Mather 419
Organizing for Inventory. Robert Iglauer 192

Patents Worth, What Are? H. A. Toulmin 291
Pensions and Wages, Industrial. John Whitmore 174, 241

Rejections, Appeals from Claim. Hugh C. Bickford 184
Requirements of a Balance-sheet Audit. Charles B. Couchman 20
Retail Method of Inventories, The. J. P. Friedman 106

Some Economic and Historical Aspects of Taxation. Charles W. Smith. 119
Some Legal Aspects of Goodwill. L. L. Briggs 429
Standard Financial-statement Form for Banks. Emanuel Saxe 37
Statements, Verification of Financial 321
Stock and Asset Valuation, No-par. Frederick H. Hurdman 81
Stock-brokerage Accounts and Their Audit. Anson Herrick 93
Students' Department. Edited by H. P. Baumann.
American Institute of Accountants Examinations, May, 1929:
Accounting Theory and Practice, Part I 58, 144
Part II 145, 226
Auditing 310
Computation of Cost of Sales 387
Illinois Accountancy Examination 378
Problem from Illinois Examination 459

PAGE
Taxation, Some Economic and Historical Aspects of. Charles W. Smith. 119
Terminology Department......................52, 136, 219, 303, 365, 451
Trust, Accounts of an Investment. Herman E. Schreiber..........161, 253

Valuation, No-par Stock and Asset. Frederick H. Hurdman......... 81
Verification of Financial Statements.............................. 321

Wages, Industrial Pensions and. John Whitmore.................174, 241
What Are Patents Worth? H. A. Toulmin......................... 291

AUTHORS OF ARTICLES IN THIS VOLUME

Hugh C. Bickford. Attorney-at-law, of Slaughter & Bickford and Patterson, Teele & Dennis, Washington, D. C.

L. L. Briggs. Assistant Professor of Economics, University of Vermont.

Charles B. Couchman. Chairman, Board of Examiners, American Institute of Accountants. Certified Public Accountant (Kansas, Missouri, New York, Oklahoma, Texas). Member of firm, Barrow, Wade, Guthrie & Co., New York.

Henry B. Fernald. Member, American Institute of Accountants. Certified Public Accountant (New Jersey, New York). Member of firm, Loomis, Suffern & Fernald, New York.

J. P. Friedman. Member, American Institute of Accountants. Certified Public Accountant (New York). Member of firm, Touche, Niven & Co., New York.

Spencer Gordon. Attorney-at-law. Member of firm, Covington, Burling & Rublee, Washington, D. C.

Anson Herrick. Member, American Institute of Accountants. Certified Public Accountant (California). Member of firm, Lester Herrick & Herrick, San Francisco.

Frederick H. Hurdman. President, American Institute of Accountants. Certified Public Accountant (New York). Member of firm, Hurdman & Cranstoun, New York.

Robert Iglauer. Certified Public Accountant (Maryland). In practice, Baltimore, Maryland.

P. Kats. Author, London, England.

Charles E. Mather. Member, American Institute of Accountants. Certified Public Accountant (Minnesota, New Jersey, New York, Ohio). Member of firm, Stagg, Mather & Hough, New York.

Emanuel Saxe. Certified Public Accountant (New York). In practice, New York.

Herman E. Schreiber. Principal, Commercial Department, Heffley School, Brooklyn, New York.

Charles W. Smith. Certified Public Accountant (Maryland, North Carolina). With Bureau of Internal Revenue, Baltimore, Maryland.

H. A. Toulmin, jr. Attorney-at-law. Member of firm, Toulmin & Toulmin, Dayton, Ohio.

John Whitmore. Member, American Institute of Accountants. Member of firm, Patterson, Teele & Dennis, New York.

The MASTER KEY *to Accounting Literature*

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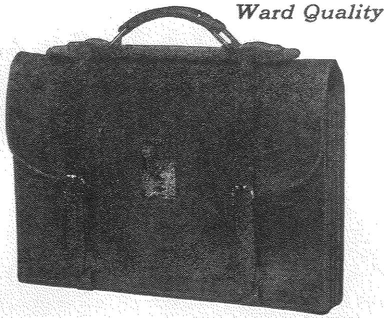

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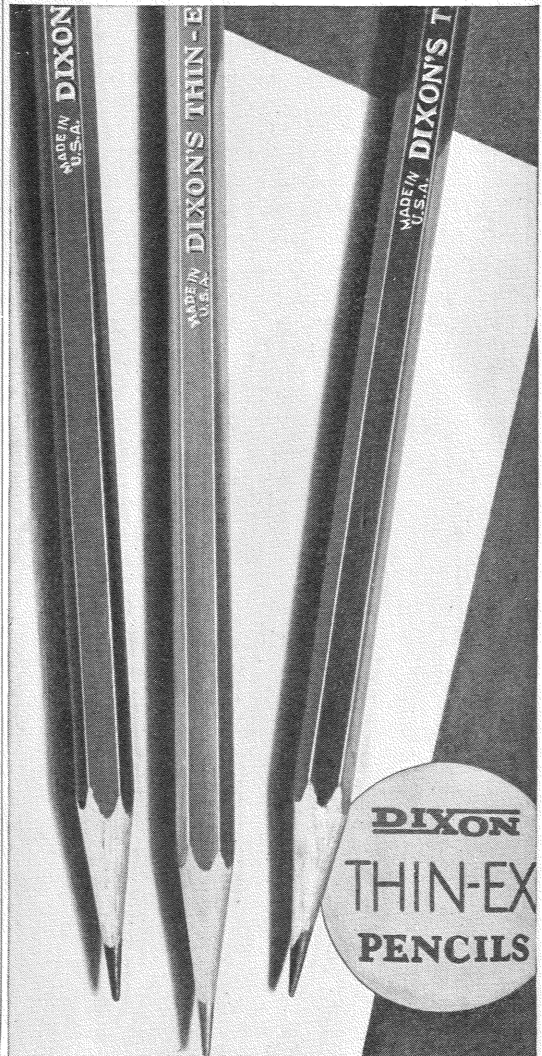

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Vouching entries
Accounts carried in foreign currency
IV — Verification of securities
V — Taking trial balances
Items not on trial balances
VI — Vouching capital assets and additions thereto
Checking inventories
Making schedules
VII — Finishing the work
Use of percentages in reports
VIII — Liabilities not taken up
Exhibits (for the client)
IX — Conduct of juniors in clients' offices
Abuses discovered in clients' offices
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