Students' Department

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AMERICAN INSTITUTE EXAMINATIONS

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EXAMINATION IN ACCOUNTING THEORY—AND PRACTICE—PART II

November 15, 1929, 1 P. M. to 6 P. M.

The candidate must answer all the following questions.

No. 3 (25 points):

Following is the balance-sheet of the Margo Manufacturing Company as at December 31, 1928:

Assets

Current:		
Cash in banks and on hand		$ 50,000
Customers' notes and accounts receivable, less reserve		300,000
Inventories		1,000,000
Total current assets		$1,350,000
Land, buildings and machinery, as appraised, less reserve for depreciation		6,200,000
Prepaid expenses		20,000
Goodwill		1,000,000
		$8,570,000

Liabilities

Current:		
Notes payable—banks		$ 800,000
Trade acceptances		400,000
Accounts payable and accrued expenses		500,000
Total current liabilities		$1,700,000
Funded debt:		
First-mortgage 6½ per cent. gold bonds	$2,100,000	
Serial gold notes	400,000	2,500,000
Capital stock:		
Authorized and issued—		
Preferred, 20,000 shares, 6 per cent. cumulative, par value, $100 each	2,000,000	
Common, 15,000 shares, par value $100 each	1,500,000	3,500,000
Surplus:		
Earned	70,000	
From appraisal of plant	800,000	870,000
		$8,570,000

In order to provide working capital necessary for the continuance of the business, it is proposed to reorganize according to the following plan:

(1) The authorized capital stock to consist of 50,000 shares of 6 per cent. cumulative preferred of a par value of $50 a share and 100,000 shares of no-par common.

(2) The preferred and common stock now outstanding to be surrendered, the present stockholders to receive, for each share of preferred stock now held, one (1) share of new preferred of $50 par, one (1) share of common, no par, and warrant entitling to purchase, on or before June 1, 1929, one-half (½) share of no-par common at $35 a share; for each share of common stock now held, two (2) shares of no-par common with warrant entitling to purchase, on or before June 1, 1929, one-half (½) share of no-par common at $35 per share.

(3) Sale, for a cash consideration of $600,000, of one of the branch plants and taking up the serial gold notes of $400,000, a security for which the plant is mortgaged. The plant to be sold is carried on the books and included in the fixed assets at $750,000, the appraised value, less depreciation.

(4) Issuance and sale of $1,250,000 seven (7) per cent. debentures at 95, the sale carrying with it a bonus of 5,000 shares of no-par common stock.

(5) Application of the proceeds of the proposed financing to the reduction of bank loans, trade acceptances and accounts payable by $600,000, $350,000 and $400,000 respectively and the balance to additional working capital.

Prepare a balance-sheet, as at December 31, 1928, after giving effect to the transactions set forth in the foregoing plan of reorganization.

The expenses relative thereto may be disregarded.

Solution:

The following explanatory entries are given to support the adjustments in the working papers shown on page 303.

(1)		
Unissued preferred stock, 6 per cent. cumulative....	$2,500,000	
Preferred stock, 6 per cent. cumulative—authorized....................................		$2,500,000
To record the authorized issue of 6 per cent. cumulative preferred stock—50,000 shares of a par value of $50 each.		
(2)		
Preferred stock, 6 per cent. cumulative (20,000 shares)....................................	2,000,000	
Unissued preferred stock, 6 per cent. cumulative (20,000 shares)..........................		1,000,000
Common stock, no-par value (20,000 shares)...		1,000,000
To record the proposed surrender of the outstanding preferred stock on the basis of one (1) share of preferred of $50 par, and one (1) share of common, no-par-value stock with warrant for one (1) share of 6 per cent. preferred stock of $100. par value.		
(3)		
Common stock (15,000 shares of $100 par)........	1,500,000	
Common stock, no-par value (30,000 shares).....		1,500,000
To record the proposed surrender of the outstanding common stock on the basis of one (1)		

share of common stock, no-par value, with warrant for one (1) share of common stock of $100. par value.

(4)

Cash	200,000	
Serial gold notes	400,000	
Surplus—from appraisal of plant	150,000	
Land, building and machinery		750,000
To record the proposed sale of branch plant, and the payment of the serial gold notes.		

(5)

Cash	1,187,500	
Discount on debentures	62,500	
Seven per cent debentures		1,250,000
To record the proposed sale of $1,250,000.00 of 7 per cent debentures at $95. A bonus of 5,000 shares of no-par common stock was given.		

NOTE—No entries can be made charging a bonus-stock account and crediting capital-stock account for nothing was received for the 5,000 shares of no-par-value stock given as a bonus. A memorandum entry showing the 5,000 shares issued should be made in the capital-stock account.

(6)

Notes payable—banks	$600,000	
Trade acceptances	350,000	
Accounts payable and accrued expenses	400,000	
Cash		$1,350,000
To record the proposed payments of certain current liabilities.		

No. 4 (10 points):

You are called upon to ascertain the extent of the fraud committed and the disposition made of the funds so acquired by an individual real-estate operator —Mr. A—who, from certain trustworthy information, seems to have been issuing bogus mortgages.

An obviously incomplete cashbook, practically all the canceled cheques and a partial list of properties and mortgages owned constitute the only available accounting records covering the apparent defaulter's transactions.

State, in detail, your method of procedure.

Solution:

From the incomplete cashbook, bank statements, endorsements, interest payments, tax bills, cancelled cheques, correspondence, purchase and duplicate sales invoices, and other available data, the auditor should compile a list showing the names and addresses, with the amounts of those parties to whom payments had been made or from whom cash had been received. These parties, except those to whom operating expenses had been paid, should be circularized with a request to send direct to the auditor, a description and the amount of any mortgages bought from or sold to Mr. A.

From the information received in reply to this letter, and from any other available records, the auditor should construct a schedule of the mortgaged

MARGO MANUFACTURING COMPANY

Balance-sheet—Working Papers December 31, 1928

	Balance-sheet Before Adjustments		Adjustments		Balance-sheet After Adjustments	
Cash on hand and in banks	$ 50,000		(4) $ 200,000	(6) $1,350,000		
			(5) 1,187,500		$ 87,500	
Customers' notes and accounts receivable—						
Less: Reserve	300,000				300,000	
Inventories	1,000,000				1,000,000	
Land, buildings and machinery, as appraised—						
Less: reserve for depreciation	6,200,000			(4) 750,000	5,450,000	
Prepaid expenses	20,000				20,000	
Goodwill	1,000,000				1,000,000	
Notes payable—banks		$ 800,000	(6) 600,000			$ 200,000
Trade acceptances		400,000	(6) 350,000			50,000
Accounts payable and accrued expenses		500,000	(6) 400,000			100,000
First mortgage—6½ per cent. gold bonds		2,100,000				2,100,000
Serial gold notes		400,000	(4) 400,000			
Capital stock:						
Preferred, 20,000 shares 6 per cent. cumulative, par value $100 each		2,000,000	(2) 2,000,000			
Common, 15,000 shares, par value $100 each		1,500,000	(3) 1,500,000			
Surplus:						
Earned		70,000				70,000
From appraisal of plant		800,000	(4) 150,000			650,000
Seven per cent. debentures				(5) 1,250,000		1,250,000
Discount on debentures			(5) 62,500		62,500	
Unissued 6 per cent. preferred cumulative capital stock			(1) 2,500,000	(2) 1,000,000	1,500,000	
Authorized capital stock:						
Preferred, 50,000 shares 6 per cent. cumulative, par value $50 each				(1) 2,500,000		2,500,000
Common, 100,000 shares, no-par value				(2) 1,000,000		
				(3) 1,500,000		2,500,000
	$8,570,000	$8,570,000	$9,350,000	$9,350,000	$9,420,000	$9,420,000

MARGO MANUFACTURING COMPANY
Balance-sheet—December 31, 1928

After giving effect to (1) the issuance of 20,000 shares of new preferred stock and 20,000 shares of no-par-value common stock in exchange for the 20,000 shares of old preferred stock, (2) the issuance of 30,000 shares of no-par-value common stock in exchange for 15,000 shares of old common stock, (3) the sale of a branch plant and the payment of the serial gold notes, (4) the issuance and sale of seven per cent. debentures, and (5) the reduction of current liabilities.

Assets

Current assets:		
Cash in banks and on hand	$ 87,500	
Customers' notes and accounts receivable, *Less:* reserve	300,000	
Inventories	1,000,000	$1,387,500
Prepaid expenses		20,000
Land, buildings, and machinery (as appraised) *less* reserve for depreciation		5,450,000
Discount on debentures		62,500
Goodwill		1,000,000
		$7,920,000

Liabilities and Net Worth

Current liabilities:			
Notes payable—banks		$ 200,000	
Trade acceptances		50,000	
Accounts payable and accrued expenses		100,000	$ 350,000
Long term indebtedness:			
Debentures, 7 per cent.		$1,250,000	
First mortgage, 6½ per cent. gold bonds		2,100,000	3,350,000
Net worth:			
Capital stock:			
Preferred—6 per cent. cumulative—Authorized—50,000 shares of a par value of $50 each	$2,500,000		
Unissued—30,000 shares	1,500,000		
Outstanding—20,000 shares		$1,000,000	
Common—authorized 100,000 shares of no-par value—Outstanding—55,000 shares		2,500,000	
Total capital stock		$3,500,000	
Surplus:			
Earned	$ 70,000		
From appraisal of plant	650,000	720,000	4,220,000
			$7,920,000

properties, with description, including those properties covered by mortgages on hand.

A search should be made of the county recorder's records to determine the amount and description of any mortgages on properties listed. A comparison of the mortgages on hand and in the hands of customers, with those obtained from the search of the records in the recorder's office, should disclose the bogus mortgages on hand and issued.

If authentic information is available to indicate the terms of sale for which Mr. A issued mortgages, investigation could be limited to the same number of years, for in order to carry on successfully, it would have been necessary for him to redeem old bogus mortgages as they matured.

Examination in Auditing

November 14, 1929, 9 A. M. to 12:30 P. M.

The candidate must answer all the following questions.

No. 1 (10 points):

(a) Define the following methods of depreciation—

(1) Straight line
(2) Reducing balance
(3) Sinking fund

(b) State briefly conditions under which you would recommend each method, and why.

Answer:

(a) The following are tentative definitions submitted by the special committee on terminology of the American Institute of Accountants and published in The Journal of Accountancy, January 1928:

Straight-line method:

"The computation of depreciation in which elapsed time is the only factor considered. Cost is distributed over the expected life equally as to years, the entry being a charge to operations and a credit to depreciation reserve. The amounts so written off are not actually segregated and invested for the depreciation fund but are left in the general funds of the business. This is the plan prescribed by income tax regulations."

Reducing-balance (diminishing-value) method:

"Where such assets as office furniture, composed of many small items, are subjected to depreciation it is common, in order to avoid the burden of keeping records for each item and to avoid numerous small reserves, to increase the percentage rate of depreciation to deduct from the value of the asset the amount of depreciation instead of establishing a reserve, and in each year after the first to apply the depreciation rate to the cost of the asset diminished by the depreciation previously provided. This method charges the highest amounts in the earliest years, a result opposite to that of the sinking-fund method."

Sinking-fund method:

"This method does not differ from the annuity method except that the funds are never used for general purposes; they are frequently invested in the purchase of bonds that have been issued against the assets on which the depreciation reserve is set up."

Annuity method:

"In applying this method, it is required to ascertain the amount of an annuity for the number of years of expected life of the asset that will, at the expiration of that time, at some fixed rate of interest, produce a sum equal to the cost or the replacement value of the asset. Then the amount of the annuity so ascertained is set aside each year to be invested for account of the depreciation fund.

This has the disadvantage that the money must actually be withdrawn from the business and set aside, building up unnecessarily large cash reserves when the money might with advantage be used in the business.

Sometimes the money nominally set aside is actually used for general corporate purposes; in that case the amount to be charged to operations each year is increased by an amount equal to the interest that would have been earned by the fund had the money been invested for its benefit. If this be done the amount set aside each year is the same as the computed diminution of residual value at the end of each year, assuming (1) that the actual service rendered in each year is the same and (2) that the present value of the future service to be rendered by the asset be computed at the interest rate on which the annuity value was based.

The earlier years then bear the smallest actual charge; this is justified by its advocates on the ground that an asset giving, say, 50 years' service is better than one giving 49 years' service by the present value of a year's service to be rendered 50 years hence; at the end of one year there will be an asset that will give 49 years' service. The charge for the first year is the depreciation so ascertained, that is, the value of one year's service to be rendered in 50 years."

(b) In most cases, the straight-line method of computing depreciation should be recommended, because of its simplicity and because it is acceptable to the internal revenue department for income tax purposes. The reducing-balance method may be recommended whenever many relatively small assets of varying life are found, or whenever it is found that the assets in the later periods require a considerable expenditure for repairs. The sinking-fund method may be recommended whenever it is found that a large investment is represented in the fixed assets which may be subject to a mortgage, and when it is desirable to accumulate a fund to retire the bonds or mortgage, or to build up a fund to replace the assets.

No. 2 (10 points):

You are called to audit the books of the Blank Corporation of Syracuse, N. Y., and you find a number of canceled voucher-cheques for considerable amounts drawn to the order of the X Company of the City of New York, with invoices attached but without bills of lading. Also there is a balance of account due the X Company for which you have received confirmation by mail. None of the materials invoiced appears in the inventory at the end of the year. The voucher-cheques are signed by the treasurer and approved for payment by the president, who is also the general manager.

The bookkeeper tells you that the goods invoiced were delivered by a motor-truck company which does not issue bills of lading but merely takes the receipt of any employee receiving the goods.

What would you do?

Answer:

The auditor should secure the invoices for merchandise from the X Company of the City of New York during the past month or two for the purpose of tracing this particular merchandise through the records of the Blank Corporation.

If the Blank Corporation is a trading business, the merchandise should be accounted for in the sales records and in the accounts receivable ledgers subsequent to the dates of purchase. A test of the margin of gross profit on such sales should be made also.

If the Blank Corporation maintains records in its receiving and stores rooms and, as a manufacturing business, has cost records which are found to be dependable and which are a part of the general accounting system, the merchandise should be traced through these records to the sales journals and accounts receivable ledgers.

Should any difficulty be encountered in following this procedure, duplicate signed receipts should be obtained from the motor truck company, and the employees whose signatures appeared thereon should be required to show the disposition of the merchandise.

In certain circumstances, the gross-profit test should be applied.

No. 3 (10 points):

(a) Securities owned may appear under three captions on the balance-sheet. Name them, and state what class of securities should be shown under each heading.

(b) How would you verify such securities in preparing a balance-sheet to submit to a bank?

Answer:

(a) Marketable securities purchased for temporary investment with surplus funds of the company should be shown as current assets. Investments made for the purpose of securing a material interest in, or control of, other companies should be shown as permanent investments. Securities which have a limited market should be shown separately on the balance-sheet, and not with the current assets.

(b) If the company is the owner of many securities in various companies, it would be well to prepare a list as follows before the securities are inspected:

(1) Dates of purchases
(2) Descriptions of securities
(3) Number of shares of stock or par value of bonds owned
(4) Cost of securities
(5) Market value of securities (if no market quotations are available, the book value of the stock should be obtained.)
(6) Interest and dividend dates
(7) Interest and dividends received
(8) Securities hypothecated, with whom, and for what purpose

In addition, the balance-sheets of the affiliated companies should be obtained.

The securities should be inspected by the auditor as soon as possible, and should be under his control until all of them have been examined. Certificates out for transfer, or those hypothecated should be confirmed by direct correspondence with the transfer agent or other holders thereof.

In his examination the auditor should determine (1) that the bond coupons which are due subsequent to the date of the examination, are intact, and (2) that the stock certificates are in the name of the company, or that they are endorsed or are accompanied by powers of attorney if in the names of individuals.

Purchase invoices should be examined in ascertaining the cost of listed stocks.

If securities owned by the company have been hypothecated such fact should be set forth in the balance-sheet.

If the total market price of the securities is less than the total book value, a reserve should be set up in the balance-sheet, unless the difference is small.

No. 4 (10 points):

State fully the principles that would guide you in verifying the valuation of

(1) raw materials,
(2) work in process,
(3) finished goods,

in making a detailed audit of a manufacturing concern. Explain your reasons.

Answer:

In verifying the valuation of raw material, work-in-process, and finished-goods inventories, the principle of cost or market, whichever is lower, should be followed. The total cost or the total market, whichever is lower, should not be used, but the principle should be applied to each item appearing in the inventory.

The larger items of raw material should be checked against the purchase invoices to secure the cost of these materials. The market price may be obtained from market quotations or price lists, or from the latest invoices for similar quantities. A careful check of the inventory accounts should show those items with little activity and these should be questioned for obsolescence or unsalability.

The valuation of the work-in-process and finished goods inventories will depend largely upon the reliability of the cost records, which should be checked carefully. The cost records should not be depended upon unless they form a part of the financial accounting system. The larger items in the work-in-process inventory should be broken down as to material, labor and factory overhead. Materials should be valued at cost or market, whichever is the lower; labor should be valued at cost unless a radical revision downward of labor rates has been recently put into effect, and the overhead charged must be reasonable. Overhead charges must not include any selling, administrative, or financial expenses. and must be distributed on an equitable basis.

The finished-goods inventories should be valued by the same method as suggested in valuing the work-in-process inventories, if no price list or market quotations are available. The larger items of finished goods sold should be checked against sales invoices and a test made of the margin of profit on such sales.

Goods out on consignment should also be valued at cost or market, whichever is lower, plus any cost incurred to the date of the inventory.

No. 5 (10 points):

Outline a programme for the audit of the first year's operations of an investment company of the type usually known as an "investment trust," managed by a firm of investment bankers.

Answer:

If at all possible, the agreement, charter, etc., under which the "investment trust" is operating should be examined before the date set for the count of the securities for the purpose of determining what class of securities may be purchased, what discretionary powers are granted in the purchase and sale of securities, and what other important powers may be given to the management.

A schedule should also be prepared from the securities ledger showing dates of purchases, descriptions, number of shares of stock or par value of bonds owned, the cost and market price, the securities hypothecated, with whom and for what purpose, interest earned, dividends received, etc.

If possible, cash, negotiable instruments and securities on hand or in the vaults should be inspected and counted at the close of business on the balance-sheet date, and in any event should be kept under control until all have been verified, to prevent substitutions. The securities should be checked against the prepared schedule and those out for safe-keeping, delivery or collateral should be confirmed by direct correspondence. In his inspection of the securities, the auditor should determine that the bond coupons which are due subsequent to the date of the examination are intact and that stock certificates are in the name of the company, or that they are endorsed or are accompanied by powers of attorney if in the names of individuals.

Any cash on hand and in banks should be counted and reconciled.

Purchase confirmations and brokers' sales slips should be checked against the purchase and sales registers, the dates and prices being especially noted. The prices should be compared also with official price lists, and a test should be made of the commission and interest computations.

Footings, cross-footings, and postings of the various records should be proven and checked.

Receipts from sale of securities should be traced through the cash-receipts book to the bank statement.

The dividend and interest record should be checked against the official list of dividends declared and interest paid and against the securities account to determine that all dividends and interest due the company for the period of ownership of the securities have been accounted for.

The fixed-asset accounts should be analyzed with attention to the propriety of charges and the adequacy of reserves for depreciation.

Expenses should be checked for authority and amount. Prepaid expenses, accruals, and other liabilities should be verified and confirmed.

Confirmations should be secured from the trustee of the amount of bonds authorized and outstanding, and from the registrar or transfer agent, or both, of the amount of each class of stock authorized and outstanding.

No. 6 (10 points):

The C & D Manufacturing Co., Inc., engages you to audit its accounts for the year ended Dec. 31, 1928, and to certify its balance-sheet as at Dec. 31, 1928, and its profit-and-loss statement for the year.

What examination of the books and accounts prior to Jan. 1, 1928 would you consider necessary?

Answer:

If the books and accounts of the C & D Manufacturing Company were not audited prior to January 1, 1928, it will be necessary to make an examination prior to that date of the fixed assets and relative reserves for depreciation, investments, and deferred charges appearing on the books at December 31, 1928.

The fixed assets and reserves for depreciation should be verified from the inception of the business to ascertain that no expenses were capitalized, that all fully depreciated and discarded assets were written off, and that adequate provision had been made for depreciation. If an appraisal had been made of these assets and is used as the basis of valuation, the auditor should verify the correctness of the entry expressing the appraised figures on the records and the subsequent additions.

Any investments or deferred charges on hand at December 31, 1928, should be verified from the time in which they first appeared in the records and an analysis should be made of the capital stock and surplus accounts from the inception of the business. The prepaid expenses, accruals, reserves and inventory at January 1, 1928, should be verified to enable the auditor to certify the statement of profit and loss for the year ended December 31, 1928.

No. 7 (10 points):

While auditing the books of the E F Corporation you find an item of $5,000 debited to notes-payable account; that it is a part payment on a note for $15,000 signed by the president individually; that the proceeds of the note were used to purchase certain stocks for the corporation; and that the certificates for those stocks are in the name of the president personally. Against the loan of $15,000 were pledged other securities (belonging to the corporation) of the book value of $20,000. The only entry of these transactions on the books of the corporation is the $5,000 mentioned above. You note further that the president alone has access to the safe-deposit box containing the corporation's securities.

(a) What is your opinion of the liability of the corporation on this note?

(b) What recommendations would you make?

Answer:

(a) As the note for $15,000 was signed by the president as an individual and not in his official capacity as president of the E F Corporation, he, as an individual, is liable for the payment of the note.

(b) The certificates of stock purchased for the corporation should be endorsed by the president, personally, sent to the transfer agent, and issued in the name of the corporation. The note payable for $15,000 on which a payment of $5,000 had been made should be paid by the corporation, by cash or with its own note.

No. 8 (10 points):

In February, 1929, you are retained to audit the accounts of an investment company for the year 1928. You find that the accounts were audited for 1927 by a certified public accountant, and you are asked to accept his list showing quantities and costs of securities owned at Dec. 31, 1927, making in your certificate whatever qualification seems desirable. You are furnished with a similar list of securities owned at Dec. 31, 1928, which you find to agree as to quantities with the securities on hand as examined by you, plus those hypothecated as collateral duly confirmed by the holders; and, as to total cost, with the balance of "securities owned" account in the general ledger.

(a) Do you consider the foregoing a sufficient verification of the "securities owned" account?

(b) If not, what additional verification would you consider necessary?

Answer:

In addition to the inspection and the checking of the securities on hand against the ledger account, the auditor should ascertain whether or not all securities which were purchased by the company and not sold are included in the securities-owned account. In his audit of the other accounts, especially the cash account, the proceeds from the sale of those securities which were on hand at December 31, 1927, and those subsequently purchased and sold prior to the date of his examination, should be traced through the cash-receipts book to the bank statement. Disbursements made for the purchase of securities should be traced to the securities-owned account and verified.

No. 9 (10 points):
What are the (a) advantages and (b) disadvantages of no-par stock?

Answer:
The advantages and disadvantages of no-par-value shares as compared with par-value stock may be listed as follows:

Advantages:

1. The par value as shown on a stock certificate is not a true indication of its real value.
2. Par-value stock is more easily sold to the credulous buyer who may be convinced of his business sagacity and acumen in purchasing a $100 par-value certificate for any price less than that amount.
3. Unless there is fraud in the consideration, a purchaser of no-par-value stock is relieved of any discount liability.
4. No-par-value stock is an aid in securing new or additional capital inasmuch as the stock may be sold at any price without incurring the burden of stock discount.
5. In the use of no-par-value stock a company has less incentive to overvalue its assets or to resort to the treasury stock subterfuge.
6. In reorganizations no-par-value stock is readily adaptable to the exigencies which may arise.

Disadvantages:

1. In the past, some difficulty was encountered in the marketing of shares bearing no-par-value inscribed on the certificates, but this difficulty has since been overcome.
2. Arbitrary bases are often used by some states in determining stock taxes, organization, operating and transfer fees of corporations with stock of no-par-value.

No. 10 (10 points):
When called in to check and approve the income-tax returns of the members of the firm M & L, you find the following conditions:
Capital investment of each partner, $50,000.
During the year M has drawn $4,500 and L, $6,500, as salaries in accordance with the partnership agreement.
Including these salaries as expense, the firm's books show a loss of $11,000 for the year, but as partners' salaries are not a deductible expense it is admitted that for income-tax purposes there has been neither loss nor gain.
As the partners share equally in gains or losses, they write the word "none" under income from partnerships on their individual returns.
(a) Are they correct?
(b) If not, state what net income or loss should be returned for this item by each partner and explain how you reach your conclusions.

Answer:
While it is true that the partnership had no profit or loss for the year after deducting salaries, "M" as an individual should report a deductible loss of $1,000 and "L" a gain of $1,000 from partnership.

If instead of drawing the salaries for the year the partners had been credited with $4,500 and $6,500, respectively, and had been charged equally with a share of the loss after providing for the salaries as an expense, the partners' capital accounts would have shown a credit of $49,000 for "M" and $51,000 for "L," as shown in the following statement:

Particulars	"M"	"L"	Together
Capital investment	$50,000	$50,000	$100,000
Salary credits	4,500	6,500	11,000
Total	$54,500	$56,500	$111,000
Deduct: Loss for year	5,500	5,500	11,000
Balance at end of year	$49,000	$51,000	$100,000

The decrease in the investment of "M" is a deductible loss and the increase in the investment of "L" is taxable income. It has been held (8 B. T. A. 914) that partnership profits may be distributed in whatever proportions determined by the partnership agreement, and further that salaries agreed upon by the partners is a determination of a basis for dividing profits.