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American Institute of Accountants

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R. H. Hassler

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# The JOURNAL of ACCOUNTANCY

VOLUME L SEPTEMBER, 1930 NUMBER 3

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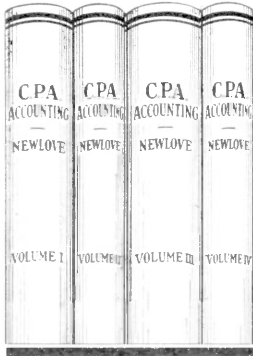


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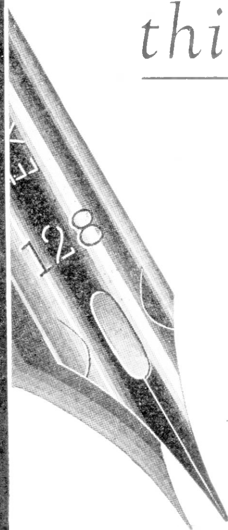


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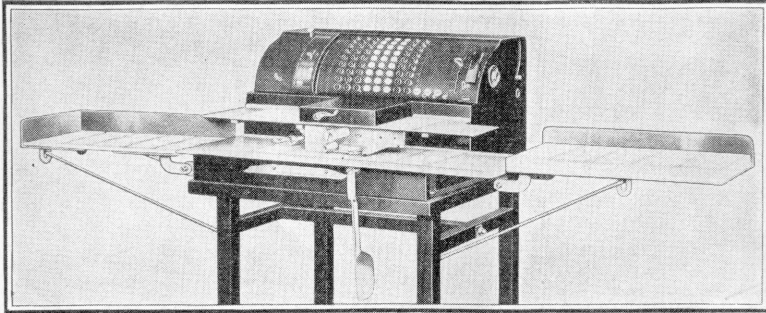

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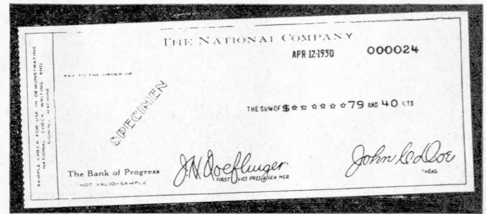


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| | 000021 | 77 | 40 | |
| | 000022 | 10 | 20 | |
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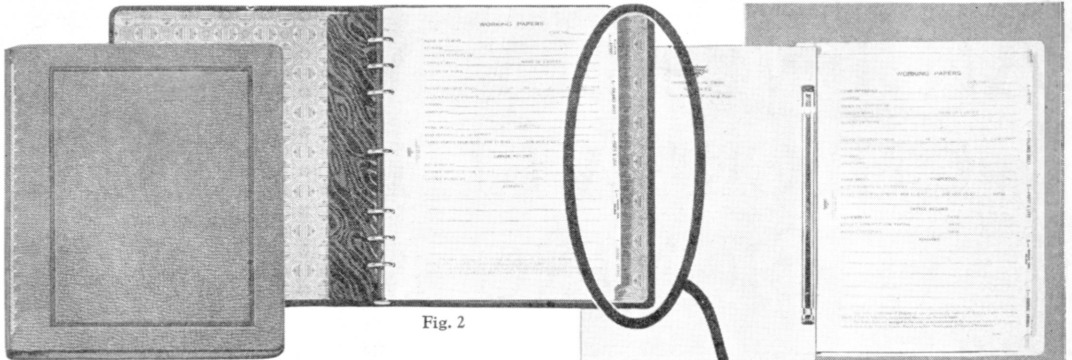


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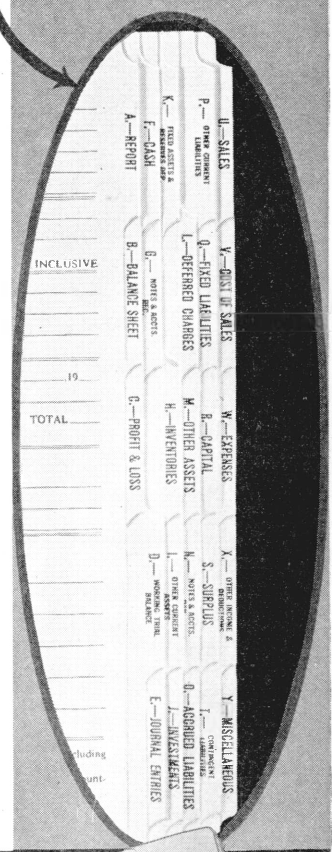

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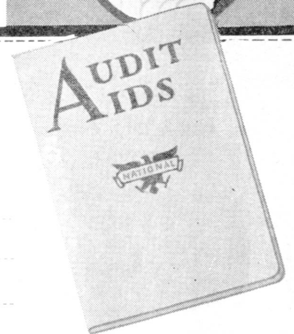


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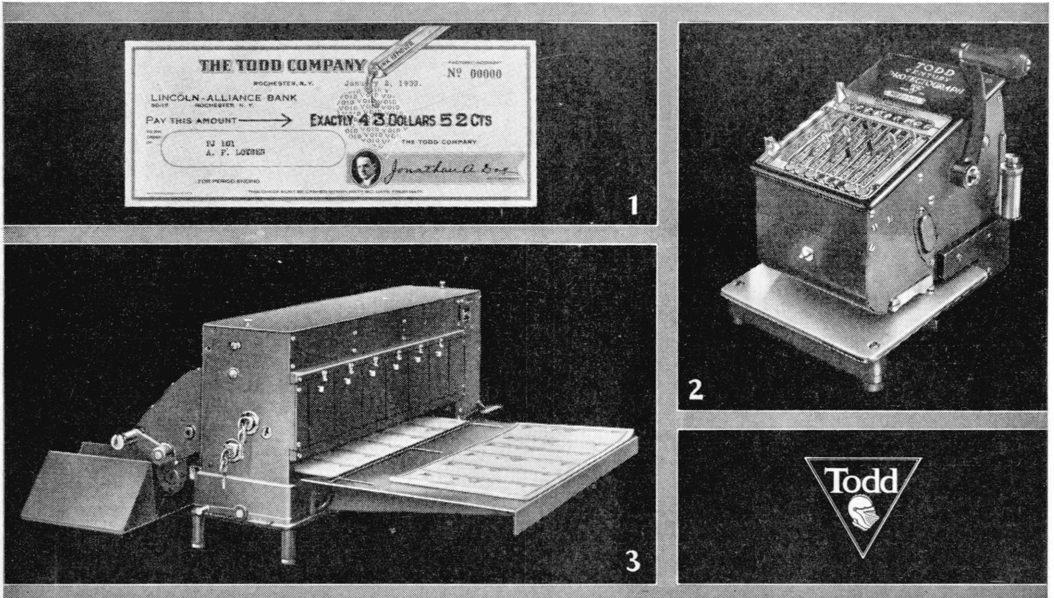


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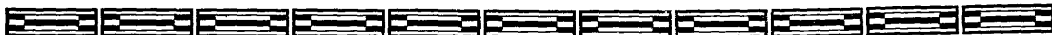


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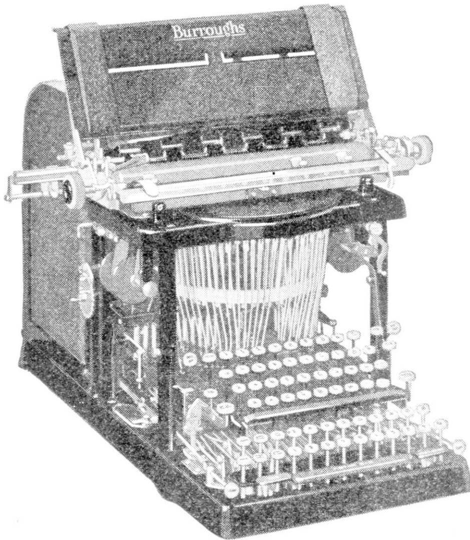

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Vol. 50 SEPTEMBER, 1930 No. 3


## EDITORIAL

**Federal Investigation of Bankruptcy Practice**

It was announced recently in the daily press that upon request of President Hoover the department of justice, through the solicitor-general's office, is about to make an investigation of bankruptcy law and practice to assist the administration in making recommendations to congress for amendment of the bankruptcy laws. It is stated that the investigation is the result of a report on conditions in the city of New York and is intended to ascertain whether such conditions are peculiar to New York or not. Investigation will be conducted in ten or more cities and the department of commerce will coöperate. In announcing this investigation, the president said that during the past five years losses through bankruptcy have exceeded three billion dollars and are now amounting to an average of seven hundred and fifty million dollars a year. When this proposal was announced, the president of the American Institute of Accountants addressed a letter to Mr. Hoover and received a reply. We reproduce these letters herewith for the information of our readers:

July 30, 1930.

HON. HERBERT HOOVER,
White House, Washington, D. C.

*Dear Mr. President:*

The accountants of this country are much interested in your proposed inquiry into the question of bankruptcy practice, as we believe many bankruptcies could be avoided if proper accounting methods were employed and that the evils growing out of bankruptcies could be mitigated by these same methods.

Believing that the American Institute of Accountants could assist in working out a solution for some of these problems, it has for some time had a committee on bankruptcy procedure, with Colonel Arthur H. Carter of Haskins & Sells as chairman, following developments in this matter very carefully. I am glad to offer the services of the Institute to the attorney general in any way that it can be helpful. We shall hold ourselves in readiness to serve you.

Respectfully submitted,

F. H. HURDMAN,
*President.*

THE WHITE HOUSE
WASHINGTON

August 4, 1930.

*My dear Mr. Hurdman:*

Your letter of July 30th is very encouraging. I do appreciate your generous offer of service and shall be glad to send it to the attorney general, who is to undertake the investigation.

Yours faithfully,

HERBERT HOOVER.

### Need of Reform Recognized

Prior to this correspondence a committee representing the bar associations and credit men in New York published a report on bankruptcies which was the subject of much popular discussion, and the American Institute of Accountants appointed a special committee which has been invited to coöperate in the consideration of conditions and the proposal of plans for reform. Everybody knows that the conditions which have existed in administration of many bankrupt estates in the neighborhood of New York have been simply atrocious and the loss which is entailed in fraudulent or incompetent administration of bankruptcies is not only appalling but largely preventable. So long as the administration of bankrupt estates is regarded as the peculiar perquisite of political favorites, it is idle to hope for reform, and it might be permissible to go further and say that so long as receivers, trustees and the like are not selected solely for their capability and honesty, there will be no reform worthy the name. An advance toward the ideal state of affairs was made when it was arranged that one of the New York banks should be appointed as administrator of bankrupt concerns, but, as we have previously pointed out, while this change makes for honesty, it does not necessarily make for efficiency. Absolute integrity is, of course, a prime necessity in such cases but it is also requisite that there be

knowledge of accounts and the application of business methods, if the utmost is to be saved out of the wreckage.

**Accountants are Best Fitted to Administer Bankrupt Estates**

There seems to be an incomprehensible objection to employing as receivers and trustees the one class which in the whole community is by training, knowledge and ability best qualified. This assertion is not pure theory. The experience which has attended the administration of bankruptcy in Great Britain demonstrates quite conclusively that the accountant is in most cases the one man who can effect saving and bring order out of chaos. Some years ago an investigation of the administration of bankruptcies was conducted and at that time this magazine published comments upon the conditions in the two countries. Since then there has not been any substantial change, we are informed, in the practice and results in Great Britain and, consequently, the figures which were significant are equally significant now. It is still the prevailing practice in Great Britain to place bankrupt concerns in the hands of accountants for administration, and out of the wreckage these men save a substantial percentage of the amounts involved. Many firms and other bankrupt concerns are so ably administered by their accountant trustees that they are enabled to carry on, to come out of bankruptcy into solvency and then to survive as going concerns. In other cases, assets which might easily be squandered, through inefficiency or worse, are realized at something approaching their true value and creditors suffer only a small percentage of the loss which threatens. In all cases the cost of administration is comparatively low. In this country it has been the practice, not only in New York, but in many other places, and perhaps one might say generally throughout the country, to appoint lawyers and others whose suitability for appointment seemed to depend largely upon their need for lucrative occupation. The result has been appalling. The figures which the president of the United States announces are eloquent. The national debt of the United States of America is at present approximately sixteen billion dollars. Our losses in a period of five years exceed three billion. In other words, we lose the extent of our enormous national debt every twenty-five years or so. And the greater part of that loss, if we may take the British experience for precedent, is avoidable. The answer is obvious.

**An Unfortunate Error**

It has been brought to our attention that *The Financial News*, London, in its issue of May 14, 1930, contains an article entitled "Fifty years of chartered accountancy," written by Lawrence R. Dicksee, emeritus professor of accountancy and business methods in the university of London, but perhaps better known in this country as the author of a standard text on auditing. In the course of that article, the following paragraph appears:

"Fifty years ago the terms 'efficiency,' 'scientific management,' and 'rationalisation' were quite unknown. Now they are being, perhaps, almost too much talked about. Solid progress has been made towards the better administration of business, and probably no profession has contributed more towards this progress than accountants. The undiscriminating reader may perhaps be inclined to think that in this respect American accountants have forged far ahead of British practitioners, but in forming this opinion he does not allow for the fact that British chartered accountants are not allowed to advertise, whereas in the states nothing is done without advertisement."

**An Explanation Which Does Not Explain**

It is somewhat distressing to find a statement of this sort appearing under the authorship of one who should be familiar with practice in this country; and at first it seemed quite clear that one of two things must have happened: either Mr. Dicksee's language had been distorted by the printer or he himself was ignorant of the facts. The secretary of the American Institute of Accountants wrote to Mr. Dicksee explaining the rule of the Institute with reference to advertising and Mr. Dicksee replied to the following effect:

"I was not unfamiliar with the provisions of your rule No. 11, and nothing was further from my thoughts than to make invidious comparisons. I think, however, that the fact remains that accountancy in one way and another receives a good deal more publicity in the states than it does in this country, with the result that the advantages of good accountancy are more widely known and better appreciated there than here. A good many practitioners over here think that our institute adopts an altogether too conservative line with regard to propaganda, and the main object of my article was, of course, to take advantage of the jubilee to do a little advertising for the profession as a whole."

It will be noted that there is no imputation of error to the printer and, therefore, it must be assumed that the author of the

article in question admits its accurate production. The alternative explanation—namely, that Mr. Dicksee was ignorant of the facts—is thrown out of court by his own letter in which he admits that he was not unfamiliar with the provisions of rule 11. The whole thing is rather confusing. If we turn back to what this eminent author says in his article in *The Financial News*, we find that "in the states nothing is done without advertisement." If we turn to the letter we find that ignorance of the real conditions is disclaimed. There must be some way of reconciling these two apparently contradictory statements, but we have not discovered it. And, really, it is lamentable that the incident should have occurred—at least it seems so to American eyes.

**Out of Tune With the Harmony**

To go back to the facts, there is, it appears, a complete misapprehension. The accounting profession in this country does not receive one-half the publicity which it receives, and deserves to receive, in Great Britain. There the profession is older, its position is more assured, and it is not necessary to inform the public what an accountant is and does. Every business man, every banker, every judge upon the bench knows of what stuff accountancy is made. We wish that the status of the profession in America were as well established as it is in Great Britain. Here there is a considerable improvement over the conditions of past years and the profession is coming into its own, but it has not achieved a position commensurate with its position abroad. There are in this country a few advertising accountants, some of whom employ press agents to sound their praises and to see that every spoken and written word is given the widest possible publicity, but they are the exceptions. Most of the work of the accounting profession is done behind the screen of a traditional silence. The American Institute of Accountants, in its code of ethics, prohibits advertisement except of certain unimportant matters, such as changes of personnel in firms, etc. Mr. Dicksee's work on auditing was one of the early texts used in the education of accountants in this country, and we trust sincerely that its American circulation was not entirely devoid of compensatory benefit. It is then all the more regrettable that one whose contact with American accountancy, although somewhat indirect, has been continuous should have so failed to grasp the principles and sentiments of the profession here. Everyone knows there is need

of international comity in all departments of life and activity. There are many differences in methods of professional practice and probably each country thinks its own way the best, but Mr. Dicksee is not aiding the cause of friendliness by invidious comparisons, whether founded on fact or fancy only—and we shall not aid the cause if we pursue the subject further.

Jobs

A correspondent sends a clipping from a western paper which reads as follows:

"A C. P. A. firm seeks experienced accountant to solicit jobs; excellent opportunity for progressive man."

It seems to our correspondent that something should be done to prevent "this sort of thing," but it is somewhat difficult to know what can be done. Everybody knows that there are lawyers, so called, whose sole value to the law firms which employ them is the amount of "business" which they bring into the firm. Ambulance-chasing is frowned upon by the bar and now and then someone is disbarred for practices which are contrary to the ethics of the bar, but so long as there are ambulances they will be chased by that sort of person to whom chasing seems lucrative. Everybody knows that there are physicians who pay commissions. A good many people know that there are architects who are not altogether innocent of receiving commissions from contractors. These things are very much like the solicitation of accounting work by so-called accountants. They are utterly damnable, but persist. The deuce of it is that there are a good many business men who have not yet learned that the accounting firm which goes hat in hand asking for employment is doing something which is contrary to the principles upon which the accounting profession is founded. The extent to which solicitation is productive in these days is far less than it was, say, fifteen years ago. More and more men in business are learning to select their accountants for excellence rather than for their much speaking. But there are still enough of the old kind left to make it seem desirable to unscrupulous firms to employ solicitors—men who go up and down the street ringing doorbells and publishing to all who will listen the peculiar merits of those whom they represent—men who will do anything to obtain an engagement, honestly if possible, but to obtain it.

**All Will Be Well**

What the advertiser in the western paper had to say was merely a frank expression of what he probably would call business sense. One can not sell merchandise without salesmen, and the argument is that one can not sell professional service without salesmen. Of course, this plea is pure folly. The experience of all professions is much the same. It does not pay to advertise if one advertises himself, and that is all that a professional man has to sell. It does pay, and pays well, discriminately to advertise inanimate things. Probably the "C. P. A. firm" which was seeking an experienced accountant to solicit business was seeking an experienced solicitor who could talk plausibly enough about accounting. Our correspondent is needlessly worried. The "C. P. A. firm" no doubt found a man after its own heart and sent him out to sound the trumpet. Perhaps some innocent soul was deceived, but one can not have very much sympathy for men of business in these days who are led astray by the specious arguments of high-pressure salesmen. One of the most remarkable persons of the latter half of the nineteenth century was Silvanus Johannes Paulus Kruger, to the wary better known for sake of brevity and facility of appellation as "Oom Paul," president of the Transvaal republic. When people were distressed by this or that, as our correspondent is distressed, it was the custom of Oom Paul to fold his hands and say, in that wonderful, deep voice of his, "Alles sal regkom" (Alles zal recht komen)—and that was pretty good philosophy.

**Savings Banks and Publicity**

An accountant with a bent for economics asks whether the competitive advertising campaigns conducted by savings banks, especially in the great cities, is compatible with the coöperative principles upon which such institutions are founded or is merely an undesirable development of the natural inclination of most of us to exalt and magnify any undertaking with which we are associated. It is quite true that of late years there has been evidence of rivalry between savings banks, and the rates of interest have seemed at times to be a little higher than conservative management might be expected to approve. Methods of computing interest have changed from the old quarterly plan to a monthly and finally to a daily basis. Today one may deposit money in many of the leading savings banks in New York,

withdraw it a few days later and receive the interest accrued during the whole period of deposit. Where in the olden times the rates were three or three and a half per centum, now four and even four and a half prevail, apparently without any indication that a return to the lower rates will be necessary. The advertising conducted by many of the largest and strongest institutions is costly. Beautiful buildings now take the place of the musty old rookeries in which the earlier banks were housed. In a word, the savings-bank industry shows all the marks of prosperity, and that is not astonishing in view of the fact that one person in every four of the entire population of some states has a "savings" account and that the average amount to the credit of depositors in some states is as high as eight hundred dollars. The altogether beneficent influence of the savings bank has done a tremendous service to the public in encouraging thrift and in making this country one of the richest in the world. To question the wisdom or propriety of heavy expenditures for publicity seems a little ungracious and possibly narrow-minded. No one can tell to what extent the enormous growth of the nation's thrift has been aided by the alluring inducements to save which have appeared in the daily press and magazines and have adorned, if so hideous an excrescence can be adorned, the ubiquitous billboard. It is doubtful whether all the people who have adopted the policy of saving would have done so without the adventitious instigation of advertisement. Perhaps it may not be going too far to believe that half the savings accounts on the books today would not be there if nothing more compelling than individual initiative had been. The appeal of future absence from financial cares, the urge to provide for the needs of one's family, the comfortable assurance that there is something put away against the coming of a rainy day—these and other valid reasons for saving have been stressed so much and so cleverly that we have become a saving people while we are at the same time the most wasteful in all the world. That paradox is due in great degree to the wholesome activities of the American savings bank. The men who have directed the policies and operations of these banks have been devoted to a noble cause and, almost without exception, they have looked more to the welfare of the people than to their own personal recompense of a monetary kind. They have known the satisfying reward of achievement. The advertising which is occasionally the subject of critical comment is a part of the general plan of a campaign

whose purpose is to bring thrift into the hearts and the homes of the nation. If it be at times competitive and therefore not absolutely altruistic, it does not defeat its main purpose. It is an expression of zeal for a good cause.

**Efficiency in High Places**

From time to time it is necessary to differ with the United States post-office department on the question of the handling of mail, and it must be admitted that most of the causes of discussion involve apparently inexplicable delays. It is a peculiar pleasure, therefore, to be able to speak well of this much-discussed branch of national activity. We have received a letter from the first assistant postmaster general returning to us a letter addressed to a man in Dawson, New Mexico, with the notation that it was undeliverable. The original letter bears the return address, "The Journal of Accountancy, 198 Broadway, New York City" and the postmark is November 25, 1911. This letter, after wandering nineteen years, has finally come home. After this no one can say that the post office is not, occasionally at any rate, efficient, even if slightly dilatory withal.

# Accounting and Office Management for Law Firms

By John L. Harvey

## Introduction

It is recognized that a description of an accounting system is usually of limited interest. This interest may extend to those who are concerned with the business to which the system may specifically apply and to accountants in general who, because of limited experience, may find something to add to their store of knowledge through a study of the descriptive matter presented.

In planning this article it was the endeavor to enhance interest in a subject, which gave promise of being rather dry, by broadening its scope to include, not only a description of the accounting records and routine, but also certain aspects of management and control which seemed to have special appeal. It was decided to avoid the purely theoretical, which might indeed produce a better system on paper at least, and to treat of a practical case as exemplified by a programme developed for a large law firm and introduced long enough ago to have had the benefit of those modifications the expediency of which was demonstrated by experience.

## Description of the Firm

The law firm for which this system was developed is composed of numerous partners, employing a large number of staff lawyers, secretaries and office assistants.

It is, in effect, a continuing entity represented by a succession of partnerships. The custom of the lawyers associated in this way has been to form a new partnership, usually to take effect as of the beginning of each calendar year. This has been done because, in an organization of its size, it is necessary to make changes in the personnel of the partnership and to alter the basis for the distribution of profits. In some respects each partnership has been distinct from every previous partnership but at the same time the firm name has not been changed and to the outsider it has been a continuation of the same partnership which was begun many years ago.

The very size of the firm renders it essential that financial information be properly collated and presented to the partners as promptly as possible. An organization of this character is somewhat loosely constructed, and such things as accounting and office matters may be neglected because the responsibility may not have been delegated to one or more of the partners with authority to act. In other words, what is everybody's business is nobody's business.

The system devised to meet the requirements of an organization of this size must provide answers to most of the problems which can arise in a law office, whether it is composed of many partners or consists of an individual lawyer carrying on alone.

For convenience of reference the successive partnerships are given consecutive numbers and are indexed by such numbers, together with the names of the partners composing the several firms and the bases for the division of profits among them.

### Problems Arising from Succession of Firms

Problems arise from the fact that the affairs of the old firms are not settled at the close of the terms of the respective partnerships so that certain of the assets continue to belong to the members of those firms and certain assets are, in effect, purchased by the latest partnership.

There remain bills to be prepared and recorded for services rendered in whole or in part by the old firms, deferred income, as represented by clients' unpaid accounts, to be collected, securities to be realized, etc.

These services are undertaken by the latest partnership which acts as custodian of the assets of the old firms and as agents for the collection of income. In fact, the relationship which arises is that of trustee and, as such, the current firm is charged with the duty of rendering a faithful account of its stewardship to the members of the old firms.

The problems are aggravated by the fact that the partners of several successive firms may have worked on the same case, and some method must be adopted for the equitable distribution of profits eventually realized when the case is closed and billed. The accounting system must provide the mechanics whereby each of the partners of the several firms may receive proper credit for his rightful share of such profits.

## Pro-forma Balance-sheet

At this point it seems advisable to introduce a balance-sheet which is a reflection of the combined financial condition of all firms at a given date.

The figures, of course, are fictitious. This balance-sheet contains the assets and liabilities of several distinct partnerships and must, therefore, be considered as a composite statement; but, after all, it sets forth within certain limitations the financial condition of this somewhat fictitious entity known as the firm.

### Composite Statement of Assets and Liabilities—All Partnerships

| *Assets* | | | |
|---|---|---|---|
| Trust fund assets (contra) | | | $ 55,000 |
| Cash in banks and on hand | | | 65,000 |
| Advances to employes | | | 2,000 |
| Deposit | | | 200 |
| Advances in hands of foreign representatives (to be accounted for) | | | 5,000 |
| Accounts receivable—clients: | | | |
| Fees and disbursements billed | | $271,000 | |
| Disbursements not billed | | 23,000 | |
| | | | 294,000 |
| Securities (book value) | | | 8,000 |
| Furniture and fixtures | $39,000 | | |
| *Less* reserve for depreciation | 9,000 | | |
| | | $30,000 | |
| Library | $21,000 | | |
| *Less* reserve for depreciation | 8,000 | | |
| | | 13,000 | 43,000 |
| Total assets | | | $472,200 |

| *Liabilities* | | |
|---|---|---|
| Trust funds (contra) | | $ 55,000 |
| Accounts payable: | | |
| Credit balances in clients' accounts | $ 2,500 | |
| Other | 1,600 | |
| | | 4,100 |
| Total liabilities | | $ 59,100 |
| Capital: | | |
| Deferred income | $299,500 | |
| Working fund | 100,000 | |
| Partners' drawing accounts | 13,600 | |
| | | 413,100 |
| | | $472,200 |

## Ownership of Assets

Assuming that this balance-sheet had been prepared as of the date of the beginning of a new partnership, the cash, furniture and fixtures, library, advances and deposits are the property of the current partnership, subject to the other liabilities and to the credit balances in partners' drawing accounts. These assets were taken over from the preceding partnership at book values as set forth in the partnership agreement. They represent the necessary working fund contributed by the partners and fixed in this case at $100,000. The accounts receivable from clients and securities, however, were not transferred and remain the property of the partners of those partnerships which rendered the services resulting in the billing to clients. The total of the book value of accounts and securities, less the credit balances in clients' accounts, is reflected on the credit side of the balance-sheet under deferred income, which is the aggregate of the recorded deferred income of all past partnerships.

As the activities of the new partnership reflect themselves in financial transactions, the accounts become somewhat mixed, inasmuch as deferred income accrues to the credit of the current partnership and is reflected in client's accounts receivable and, possibly, securities account. In addition to the asset shown on the balance-sheet, there is the value of the services rendered to clients which has not been billed.

It should be noted that the accounts are kept on a cash basis and that income is credited to the respective partnerships only when collected. It can readily be recognized that it would be impracticable to attempt to value accounts receivable so that the partners of the new firm could be charged with a fair amount for this asset. It is much fairer to credit the partners of the old firms as collections are made on these accounts receivable. No recognition is given in the statement to the value of unbilled services, because even the lawyer in charge of the case can not foresee what turn of events may make it desirable to bill a fee much higher or lower than was contemplated until the very close of the case. A strict control, however, is maintained over unbilled services.

In the case of securities, in some instances it may be practicable to transfer the ownership of these to the incoming firm, if the securities have a marketable value, but usually securities come into the possession of the firm as compensation, in whole or in part, for services rendered in the organization and reorganization

of corporations; their value is, to say the least, often problematical; and it has been considered advisable for the firms rendering the services resulting in the receipt of compensation in this form to retain the ownership of the securities and to receive the distribution of proceeds when the sale or other disposition is effected.

### Working Fund

Though capital may not be an important factor in the production of income in a law firm, as has been recognized by the commissioner of internal revenue, it is nevertheless essential in the conduct of the business of the firm. It is wise to set up on the books that amount which experience has indicated is needed to provide for equipment and current working funds.

Upon the formation of a new partnership, the drawing accounts of the partners of the old firm are credited and the drawing accounts of the partners of the new firm are charged with the amount of the fund. It should be remembered, of course, that the personnel of the partnerships does not radically change with the formation of each new partnership or, in other words, that most of the partners of the preceding firm become partners in the new firm. Therefore, this charge and credit to the partners' drawing accounts does not have very much effect upon the lawyers who continue as partners unless their percentages are radically altered. With regard to the drawing account of the incoming partner, however, it has the effect of creating a debit balance. The new partner may pay into the firm his pro-rata share of the working fund if he so desires but, in actual practice, this is not usually done and his drawing account is shown as an overdraft until his contributions to the fund out of income are sufficient to meet the charge. Under this plan, of course, the fund is temporarily reduced by the amount of the overdraft.

It is clear that the firm must have working capital, and the method adopted provides an equitable assessment against each partner in order to provide this most necessary fund. Before this method was adopted it was found that frequently the funds of the firm became so low, by the withdrawals of partners, that it was necessary to seek contributions from those partners who had already drawn the money. This was an unsatisfactory situation. No one likes to pay back funds that he has already received and made disposition of, and, further, it is practically impossible to

recover from all partners their just proportions of the amount needed. Under the scheme of setting apart the working-capital fund in a separate account, the balances in the partners' drawing accounts show exactly what the partners may draw without crippling the operations of the firm; and a valuable control of the drawing accounts is obtained.

### Securities

A law firm which does a large amount of corporation work, particularly in the formation of new companies or the reorganization of others, may find itself in possession of securities of the corporations for which it acted. Securities may, of course, be purchased as an investment, but that is unusual and the only question involved in that case would be the disposition of such securities at the time of the organization of a new partnership. If they had a market value they would probably be charged to the new partnership at that value, the difference being credited or charged, as the case might be, to the partners of the firm making the purchase. It is more usual to find that securities come into the possession of the firm as a payment for services rendered. In one instance, a block of securities was received partly in payment for services and partly for a cash payment made by the firm.

Securities accepted from clients in payment of fee may be recorded on the books in one of two ways: a cash fee may have been determined and the securities accepted in lieu of this, or the fee may be said to have consisted of so many shares of stock or other securities at no stated value. In the latter case, for the purpose of record, a value must be placed upon securities and if this value is indeterminate a nominal value of $1.00 can be used. In either case the valuation will be offset by a credit for the same amount to deferred income. Some time may pass before the securities can be marketed to advantage, and it is, therefore, important to see that the extent of the interest of each partnership in these securities is determined when they are received. It is well that a memorandum be prepared by the partners or those responsible for the distribution of fees among partnerships setting forth the interest of each partnership in the securities. Any sums received either on account of the sale of these securities or on account of the income from them will, of course, be credited to the appropriate partnerships as their interests may appear.

An interesting situation arises in case a partnership receives securities in part as a payment for services rendered and at the same time pays cash for part of the securities acquired. To illustrate it may be assumed that partnerships Nos. 2 and 3 assisted in the organization of a corporation. This work is billed by partnership No. 4 at $75,000. The client corporation makes an offer to deliver to the firm 1,000 shares of its capital stock, which has no ascertainable value, in full payment for all services rendered and for a cash payment of $25,000 by the firm. The offer is accepted. Such a transaction is susceptible to various methods of treatment and it is, therefore, important that an agreement be reached as to the respective interests in the securities of the various partnerships concerned. In the case used for illustration, it was decided that the $25,000 payment was an investment of partnership No. 4, represented by one-fourth of the stock acquired, or 250 shares. This ratio was determined by valuing the total stock acquired, 1,000 shares, at $100,000, or the sum of the fee for services and the cash payment. The other three fourths, or 750 shares, were allocated to partnerships Nos. 2 and 3 as payment for their fee of $75,000 on the basis of $50,000 to No. 2 and $25,000 to No. 3. The latter transaction was reflected on the books by a charge of $75,000 to securities and a like credit to deferred income, the $25,000 having been charged to securities account direct from the cashbook.

Under these conditions, any income from or profit or loss on the disposition of the 250 shares would accrue to the partners of No. 4 partnership. The partners of Nos. 2 and 3 would be entitled to any income arising from the 750 shares and would receive credit for the proceeds from sale in proportion to their respective interests.

If it were decided that the cash payment was made to protect the interests of partnerships Nos. 2 and 3, then, of course, No. 4 should be given the benefit of any amount received in realization up to $25,000 and Nos. 2 and 3 should bear any loss or receive any profit when the shares were sold.

As a matter of bookkeeping, when these securities of partnerships Nos. 2 and 3 are sold an entry must be made clearing from the securities account and from deferred income the book value of the securities sold. It should be remembered, however, that it may be agreeable to all concerned for the succeeding partnership to take over any or all securities at an agreed valuation.

## PARTNERS CLASSIFIED AS TO BASIS OF COMPENSATION

The division of profits or compensation to the partners is, of course, to be found in the partnership agreement. Compensation varies considerably and the partners may be classified as follows:

- Partners sharing profits or losses on percentage basis;
- Partners sharing profits on a percentage basis but guaranteed a fixed compensation from all partnerships for a specified period, whether earned or not, through the application of the percentage to which they are entitled;
- Partners sharing profits on a percentage basis but guaranteed a fixed compensation from a specified partnership, whether earned or not, through the application of the percentage to which they are entitled;
- Active partners drawing a fixed amount without relation to the profits;
- Inactive partners receiving a fixed allowance for the privilege of using their names.

## PARTNERS' GUARANTEES

It has already been pointed out that it is sometimes customary to give a junior partner a guarantee. In the firm whose affairs are the basis of these notes, the partnership included three partners who were each given a guarantee of a fixed amount. It was stipulated in the agreement that "all amounts drawn by them hereunder shall be repaid to the partnership without interest, out of their respective shares of the partnership profits, as and when collected and distributed and not otherwise." It should be borne in mind that income is credited to the partners' accounts only upon the collection of cash and that the earnings of any one partnership may not be collected in total for a number of years. It is possible that the share of the total earnings of a guaranteed partner on the basis of his percentage, as set forth in the agreement, may not equal the amount which he may draw under this guarantee. If, in the first year of the partnership, the income on a cash basis is not sufficient to meet the guarantee, as is usually the case, the best method of handling the situation is to charge the excess to the other partners immediately. In other words, the income of the partnership is distributed first to guaranteed partners to the extent of their guarantee and then to the remaining partners. Any subsequent income of the partners re-

ceiving the guarantee from the particular partnership will go to the credit of the other partners until the excess is liquidated.

It is very important that the partnership agreement should clearly express the intention of the partners in respect to these guarantees.

## Partnership Agreement

It should be unnecessary perhaps to point out that the partnership agreement should be carefully drawn and should cover all matters which may occasion misunderstanding among the partners when put into effect. The agreement, of course, will state the names of the partners, the duration of the partnership, the proportionate share of each partner in the profits and losses, the compensation to partners who are to receive fixed compensations and the amounts of the drawings of those partners who, while receiving a fixed percentage of the profits, have been guaranteed a minimum compensation. The amount of the working fund as well as the method under which the business affairs of the partnership are to be conducted should be set forth. The question as to the termination of the partnership in the event of death or retirement of a partner should be answered. Another item which might properly be included in the partnership agreement is a provision that all the partners should devote all of their time to the interest of the firm and that all remuneration received by them should be turned into the firm as part of its income. It has been found, particularly in the case of corporation work such as promotions and mergers, that after the fee has been paid to the firm the client will sometimes donate to the individual lawyer handling the work some personal remuneration which may take the form of stock of the corporation. Likewise, the individual partners frequently act as directors in corporations organized by the firm and receive fees for their services. In these instances there seems to be little question that the remuneration received by the individual partners belongs to the firm.

It is not necessary to discuss all the questions with respect to partnership agreements, as it is recognized that this is largely a legal matter, but it is well to point out that partnership agreements should cover, in a way which can not be misconstrued, those points which have a distinct bearing on accounting matters and may, if not clearly defined, cause some disagreement among the partners.

### Business Organization

In a large organization it is necessary to delegate to certain persons authority to conduct the business of the partnership: that is, to keep the books, to pay the bills, to collect fees, to hire and discharge employes and to render other similar duties. A good many of these duties, of course, can be delegated to an office manager. It is wise, however, to arrange that partners may oversee the work of the office, direct the business activities, decide questions of policy and maintain supervision over finances and accounts.

### Executive or Management Committee

One firm has solved its problem of management by means of an executive committee composed of four partners who determine all ordinary questions of office management and procedure. The partnership agreement states that the committee shall have power to decide all matters relating to

(a) The employment and discharge of associates and other employes and the fixing of their compensation;
(b) The adequacy, operation, management and conduct of all office departments and services, including the assignment of associates to work;
(c) The division between different firms of fees for professional services extending over a period of more than one firm; and
(d) Any other matters expressly referred to it by a majority in interest of the partners.

All other questions of policy and management are determined by the majority in interest of the partners.

It is obvious that, inasmuch as the outside accountant must rely on the decisions of this committee in many cases, such as the distribution of fees among partnerships, approval of financial transactions, etc., the executive committee should keep a record of its proceedings. In a partnership consisting of many partners, if every partner, individually, is permitted to have full power to make important decisions, sign cheques, approve bills, etc., it is plain that the decision of one partner can hardly be accepted as expressing the approval of all other partners or the majority of them. The method of placing authority in a small executive committee makes it possible to accept the decisions of this committee as indicating the wishes of at least the majority of the partners in interest.

## Distribution of Fees

It frequently happens that succeeding partnerships may carry on the work of preceding partnerships in a case, and at the conclusion of the whole matter it becomes necessary to distribute equitably the resulting fee over the partnerships which did the work. To make an equitable distribution involves careful consideration in order that no injustice may be done as among partners of the various firms. If the time element were the only one involved, of course, it would be possible to distribute the fee on a time basis. Fortunately for lawyers their fees are not always based on the time employed at specified rates but may be rather calculated on the basis of the value of the services rendered. Therefore, when the bill is prepared the question of distribution should be settled, while the matter is fresh in mind. If the distribution be left until the fee is collected and this collection be somewhat deferred, the whole matter becomes obscure and it is more likely that there will be an unfair distribution than it would have been when the matter was closed and the bill rendered. The accounting system should provide for recording on the duplicate copy of the bill the distribution of the fee, which should be approved by the authority designated.

This whole question of authority for the distribution of fees had given trouble prior to the installation of a new system and the partners were of the opinion that this matter merited the approval of the executive committee in every case. The system as originally installed did provide that although the partners might make the distribution of the fees themselves, the final approval of the executive committee for all distributions so made was required. In practice, however, it was found that too much time was being given by the executive committee to this work, and it was decided that in cases where the fee covered work performed by more than one partnership the partner in charge of the work should have full power to decide the appropriate distribution, subject to whatever adjustment might be made by the committee should it at any time see fit to review the original distribution.

Although there are numerous instances in which the time spent on a case does not afford a basis for an equitable distribution of the fee, there are other cases in which it does. In the instance under consideration it was decided that where the partner in charge considered it fair, the distribution should be made by the book-

keeper on a basis of an approved formula. This formula was based on an hourly unit plan, partners and clerks being rated as follows:

| | |
|---|---|
| Senior partners | 6 units |
| Junior partners | 4 " |
| Senior clerks | 2 " |
| Junior clerks | 1 unit |

Junior clerks are those receiving up to $5,000 a year. Junior partners are those specifically designated as such.

It was agreed that in order to assist in the work of the outside audit any partner wishing the distribution to be made on this basis should indicate his intention on the billing form.

CHEQUE SIGNING AND APPROVALS

Sometimes it is the practice of firms to permit cheques to be signed by any partner and to have the bills and payrolls approved in like manner. This practice, of course, not only wastes the time of partners but also the time of the office employes who seek to obtain approvals or signatures and must find a willing partner before these can be obtained. Experience demonstrates that the authority to sign cheques should be delegated to one partner or to a trustworthy employe who would be instructed to draw cheques for duly authorized payments only. A complete schedule of approvals may be drawn up and approved by the executive committee, so that it will be clear who should approve payments and the limits of these approvals. The following schedule adopted in the firm whose affairs are the basis of these notes may be of interest:

| Nature of expenditure | Approval |
|---|---|
| Original salaries and adjustments: | |
| Lawyers, law clerks, etc. | Management committee |
| Clerical and executive staff | " " |
| Stenographic staff | Chief clerk |
| Boys | " " |
| Current and normal office expenses—stenographic costs, stationery, telephone, repairs, water, ice, lighting, periodicals, carfares, etc. | " " |
| Extraordinary expenditures (contributions, entertaining, purchases of furniture, etc.): | |
| Up to $25 | " " |
| $25 to $200 | A partner |
| Above $200 | Management committee |
| Disbursements for clients (except expense reports *re* trips, etc.): | |
| Up to $1,000 | Chief clerk |
| Above $1,000 | A partner |

| Nature of expenditure | Approval |
|---|---|
| Partners' expense reports: | |
| Up to $250 | His own signature |
| $250 to $500 | Another partner |
| Above $500 | Management committee |
| Other expense reports: | |
| Up to $1,000 | A partner |
| Above $1,000 | Management committee |

## Time Records

Each lawyer is required to enter in a diary the time spent on each case, together with a description of the work performed. These are forwarded periodically to the clerk in charge of the time records. These records are loose-leaf sheets, the original and duplicate being of different colors, which are kept in a loose-leaf binder. They are headed with case number, name and number of the client, brief description of the matter, date begun and date completed. They contain space, in columnar form, in which to type particulars of the work done by each lawyer, his initials, the date and the time in hours. It is a rigid rule that the original sheets shall never leave the files, the duplicates being provided for the use of lawyers and others in the preparation of bills or for any other purpose. As bills are rendered, the fact is noted on both the original and duplicate by means of a rubber stamp indicating the date and number of the bill. This information, of course, comes from the accounting department and should be brought up to date each day.

No value is entered on the books of account for unbilled time—that is, no attempt is made to value work in process. However, a strict control is kept over time. This is done by means of a monthly summary which contains columns enough to provide for each day in the month. The lawyers' names appear at the left margin. The hours are summarized under each lawyer's name each day on this summary sheet, the time having been assembled from the lawyers' diaries. The time spent on the various duties each month is assembled and against this total there is credited the time billed each month and the time written off as unbillable. A trial balance of the time records is taken periodically and on this trial balance the total unbilled time of each lawyer on each case is shown. The trial balance is brought periodically to the attention of the executive committee which is thus afforded information about the work in process and the unprofitable time spent. In

order that this accumulation of unbilled time may be kept at a minimum, action is taken by the executive committee to see that time which can not be billed is eliminated from the records.

### Clients' Bills

Clients' bills are prepared by the lawyer in charge of the matter to be billed. They are prepared in duplicate, the original for the client and the duplicate for the permanent office file. The time record contains the information necessary for the preparation of the bill.

The duplicate copy of the bill should provide a space in which to record the distribution of the credit among partnerships. It is essential that this information be recorded when the bill is prepared. The lawyer who makes the distribution should initial the duplicate. This record, of course, greatly facilitates the determination of the correctness of credits among partnerships by the outside auditor.

Details of disbursements made for the account of the client and stenographic charges are furnished by the accounting department upon receiving advice that the bill is in course of preparation.

After the bill has been prepared it is returned to the accounting department for review, the original is mailed or delivered and the duplicate, from which entry is made in the clients' charge journal, is filed.

### Stenographic Charges

It is the practice of the firm in question to bill clients for services of the stenographic department at a price per folio. Whether this practice is advisable or not, of course, is open to question, on the theory that a client is far less apt to dispute a bill for $25,000 than one for $24,000, plus a relatively small charge for stenographic services. However, it may be of interest to review the system.

Each stenographer is required to fill out weekly a form showing the number of folios and copies made for clients each day and specifying the clients to whom these are chargeable. These forms contain a weekly summary classified according to clients. The totals of the folios and copies made for each client are posted to his account in a ledger known as the "stenographic ledger." At this time no charge is made on the general books but reference is made to this ledger when the invoice is prepared. When the

charges are billed to clients, notation to this effect is made in the stenographic ledger.

### Disbursements for the Account of Clients

There is a separate ledger to which are posted from the cash-disbursement book all disbursements for the account of clients. This ledger is, of course, controlled by an account in the general ledger, to which postings are made in total. When the client is billed, reference is made to this ledger and the total amount of the disbursements, in most cases, is added to the bill. The total of each bill is charged to the client's account in the clients' ledger and proper credit is made in the disbursement ledger.

### Identifying and Indexing Cases

The number of cases and the diversity of clientele of a large law office make it essential that each new case be identified promptly. This can be done by using an established description and a uniform number for each case, which will make it possible to classify accurately all matter relating to a particular case, such as time spent, bills rendered, disbursements made, stenographic services, correspondence, documents, etc. By the use of standard numbers the time records, disbursement ledger, stenographic ledger, clients' ledger and files are coördinated and cross reference is expedited.

The description of the case is established by the lawyer in charge, who prepares a set of slips on which is set forth the title of the new work about to be undertaken. These slips are forwarded to the time ledger clerk who indexes and numbers them before they are distributed to the various departments interested. The numbers are noted on all ledger sheets, time records and files and consist of a primary number for the client and a secondary number for the particular matter handled for him.

### Periodical Review of Accounts and Records by Management Committee

Too great emphasis can not be laid on the necessity of having either the partners themselves or the executive committee, for them, review the accounts, so that they may be kept free from deadwood.

A trial balance of unpaid charges made to clients for fees and disbursements should be prepared and submitted to the com-

mittee each month. If this is done the committee is in a position to take whatever steps may be considered advisable to collect those balances which are due and to write off the balances which have become uncollectible.

Disbursements not billed should also be reviewed periodically and, where such disbursements are not to be billed, formal action should be taken to remove them from the accounts. Likewise the balances of the time accounts in hours should be scrutinized and the time control relieved of charges which will not result in fee. For the convenience of the outside auditor who may audit the books, all charge-offs should be supported by formal authorization of the management committee.

## Trust Funds

Money in the nature of trust funds which may come into the hands of the firm should never be merged with the funds of the firm but should be kept distinct and deposited in separate bank accounts. It sometimes happens that the aggregate of these funds results in the accumulation of a bank balance sufficiently large to be credited with interest by the bank, although, possibly, no individual item would be sufficiently large. The problem then arises as to the proper distribution of the interest credited. It may be argued that this amount should be distributed pro rata to those having title to the trust funds which caused it to arise. In the case in mind, however, this interest was credited to the income of the partnership, perhaps on the theory that it may have represented some small reimbursement for the expenses involved in the handling of the funds. However, it may be advisable to keep separate any large amount which may be received and either place it in a separate bank account or invest it in securities which are legal for trust funds, so that the earnings from this fund may go to the proper beneficiary.

## Vouchers Supporting Disbursements

Disbursements made by the firm either for its own account or for the account of clients, should be supported by properly approved vouchers. These vouchers may take the form of invoices, payrolls, receipts or requests by the partners for cheques. The approvals should, of course, conform to the programme laid down by the management committee and should be registered on the

voucher by the use of a rubber stamp which may be designed somewhat like the following:

Footed and ext................. Inv. No.........
Charge account..................................
Charge client...................... No.........
Case............................... No.........
Approved........................................

A form is provided to meet the case when a partner requires a cheque and does not offer a supporting voucher. These applications for cheques, of course, are governed by the rules of the executive committee.

All vouchers are numbered consecutively and entered in a register. While the accounts are kept on a cash basis, it has been found advisable to register invoices. The register provided is a simple form having columnar divisions from left to right as follows: date, voucher number, name, amount, payment date, cheque number and remarks. This record is not controlled by the general ledger.

When an invoice is paid, the invoice number is entered in the cashbook and the date and cheque number are entered in the register so that at all times a record of the unpaid invoices is available.

If the invoice is incurred for the account of a client, the client's name, or, if this is unknown at the time, a warning notation is entered immediately in the register in the column headed "remarks." If it becomes necessary to bill a client for disbursements before actual payment has been made, the register can be consulted and the information as to the unpaid bill can be obtained from it.

## Books and Records

The books in use are as follows: general ledger, private ledger, clients' ledger, disbursement ledger, cash receipts book, cash disbursements book, petty-cash book, general journal, private journal, stenographic journal, stenographic ledger, clients' charge journal, register of vouchers, expense distribution book, time ledger and time and stenographic controls.

The private ledger and journal are not essential, but were introduced in this particular concern so that the individual accounts with the partners could be kept in confidence.

The general ledger will contain, in addition to any assets and liabilities not enumerated, the following accounts:

*Accounts usually with debit balances:*

- Cash
- Petty cash
- Trust fund assets
- Clients (control for clients' ledger)
- Disbursements not billed (control for disbursements ledger)
- Securities
- Expenses (control for expense distribution book)
- Advances (to be accounted for)
- Furniture and fixtures
- Library

*Accounts usually with credit balances:*

- Trust funds (contra to trust fund assets)
- Accounts payable
- Deferred income
- Interest income
- Income accounts (one for each partnership)
- Private ledger (control for private ledger)
- Reserve for depreciation
- Working fund

Deferred income account will be credited in monthly totals with fees and stenographic charges billed to clients, as disclosed by the clients' charge journal. It will also be credited with the total disbursements made for the accounts of clients, as disclosed by the cash disbursement book. It will be charged with the total amount collected from clients each month, as disclosed by the cash receipts book. If securities are accepted in payment of fee and these securities are carried as deferred income until sold, this account will also be credited with the value of such securities when received and debited with the same value when they are sold. The balance in the account, therefore, will represent the total amount due from clients, plus the book value of the securities carried as deferred income, and it should, of course, equal the aggregate of the balances in the clients' accounts, disbursements unbilled and the securities carried as deferred income.

Inasmuch as there are several partnerships for which income is being collected, it will be necessary to maintain one income account for each partnership. Each of these accounts will be credited monthly with income collected, as disclosed by the cash receipts book. The income account for the current partnership will be charged and deferred income account will be credited each month with total disbursements (excluding stenographic charges),

as shown by the cash disbursement book. These income accounts will be closed each month by credits to the individual partners' accounts in the private ledger.

It will be noted from the above that disbursements made for the account of clients are treated as deductions from income collected. There may be some argument about this, but it is felt that these charges, in effect, are expenses of operation and, inasmuch as income is determined on a cash basis and these amounts must necessarily be disbursed in cash, they result actually in reduction of cash income. Then, again, it is not always the custom to bill disbursements as such and it is often impossible to tell whether disbursements will be billed to the client or not until the time comes to render a bill. The department of internal revenue has taken no exception to this procedure with reference to income taxes, in the case of the firm whose accounts form the basis for this article.

The expense distribution book is a simple columnar book having columns to accommodate the various expense accounts. The individual expenses are posted from the cash disbursement book, in which the account number and amount of each expense payment is recorded.

The account classification in use is as follows:

100 Salaries—lawyers
101 " —office staff
102 Stenographic department—salaries
103 " " —rent
104 " " —stationery
105 " " —repairs and upkeep
106 " " —miscellaneous
107 Rent
108 Light and heat
109 Cleaning
110 Water, ice and towels
111 Time-clock service
112 Dues
113 Charity
114 Telegrams and cables
115 Telephone
116 Traveling expense
117 Stationery
118 Periodicals
119 Library upkeep and expense
120 Repairs to furniture and fixtures
121 Publicity

CASH RECEIPTS

| DATE | | TOTAL RECEIPTS | | CLIENTS | | PARTNERSHIPS | | | | SUNDRY | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | TRUSTEE | GENERAL | FOL | AMOUNT | No.— | No.— | OTHER No | OTHER AMOUNT | ACCOUNT | FOR | AMOUNT |
| | | A | B | | C | D | E | | F | | | G |

CASH DISBURSEMENTS

| DATE | | CHECK No | VOUCHER No | TOTAL DISB. | | CLIENTS | | | EXPENSE | | L.- LIBRARY | PARTNERS' DRAWINGS | | SUNDRY | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | TRUSTEE | GENERAL | CASE No | FOL | AMOUNT | ACCT. | AMOUNT | F.- FUR.+FIX. | FOL | AMOUNT | ACCOUNT | FOL | AMOUNT |

122 Bank charges
123 Interest
124 Paris office expense
125 Depreciation—library
126 " —furniture and fixtures

A copy of the form for the cash receipts book is submitted on page 189.

The total of each column will be posted as follows:

(A) To the debit of the trustee fund account and to the credit of the account showing the liability of the firm as custodian of the funds of others.
(B) To the debit of the general cash account.
(C) To the credit of the control account for clients' accounts and to the debit of the deferred income account.
(D, E and F) The collections made on clients' accounts will be distributed in these columns and the totals posted to the income accounts of the various partnerships. The aggregate, of course, will equal the total of column "C."

In effect a journal entry will be made each month in which the total of "C," representing total income collected, will be charged to deferred income account, which will have been previously credited with the fees and disbursements billed clients, and the totals of "D," "E" and "F" will be credited to the respective income accounts of the various partnerships. The items in column "G" will, of course, be posted individually.

With reference to the cash disbursement book, form for which appears on page 189, it should be noted that the disbursements recorded therein for the account of clients should be posted to the individual accounts in the disbursement ledger and the total to the account in the general ledger controlling the former. It must be emphasized that the individual postings should be made daily so that when the occasion arises for bills these charges may be a matter of record in the disbursement ledger.

The clients' ledger is kept on the loose-leaf system and is a simple debit and credit ledger, except that it provides information as to the division of the charge as to its elements, fee, stenographic charges and disbursements, and also as to partnerships which receive credit. The case number and invoice number are also entered for reference purposes. Reference to this ledger will show to what partnership or partnerships a fee received shall be credited and it affords the basis for an analytical trial balance of

CLIENTS LEDGER

| Date | | Case No | Invoice No | Invoice Fol | Total Charge | Distribution Part. No | Distribution Fee | Distribution Steno. | Disb. | Credit Date | | Credit Fol | Credit Amount |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | | |

deferred income classified as to partnerships and the composition of the balances due from clients.

A copy of the form in use is shown above.

The clients' charge journal follows the form of the clients' ledger except, of course, that the credit columns are omitted.

## Reports

The final test of any system is that it produce promptly and accurately such information as may guide the management of the concern. It is essential, of course, that the management committee, and through it the partners, be kept advised from time to time of the financial condition of the firm and, if one may use this term with reference to lawyers' accounts, the results of operation.

In the case under review the reports were designed so that they could be inserted in a loose-leaf binder which was of the flexible type for ease in handling. It was decided that these reports should not be prepared for each partner but that they should be limited to three copies, two of which are furnished to the management committee and one for the office file. The copies in the hands of the management committee are open for inspection by the partners and, if the management committee is functioning correctly, it will see to it that each partner reviews the reports.

The forms may be described as follows:

*Issued weekly:*

Cash receipts and disbursements—in detail as to the week with cumulative totals for month and year.

*Issued monthly:*

Composite statement of assets and liabilities of all partnerships.

Accounts receivable from clients, showing date of billing.

Advances.

Income and expense, showing gross income classified as to partnerships and expenses in total supported by detailed schedule. These statements contain transactions for the year to date and include a comparison with the transactions of the previous year to the same date.

Partners' accounts—the left column on this sheet is a total column and provides for the following:

Balance beginning of period.

Add net income of partnerships, shown separately by partnerships.

Deduct withdrawals.

Balance end of period.

Columns to the right headed with the name of each partner provide the means of showing the spread of the above totals among partners.

Bills rendered to clients during the month—analyzed as to fee, disbursements and stenographic charges.

Statement of collections by month—in detail, classified by partnerships.

*Issued quarterly or oftener as required:*

Disbursement ledger balances—analyzed by year of origin.

Stenographic ledger balances.

Time ledger balances—shown by partners.

*Issued as required:*

Schedule of securities.

Schedule of trust funds.

# Some Cost Accounting Terms

## AN INTRODUCTION TO A DISCUSSION OF THE NATURE AND USES OF FACTORY ACCOUNTS

BY JOHN WHITMORE

When names seem expressive, but are not accurately so, there is a danger that they may govern our conceptions of the things named, and if these are still in process of development, names may even determine their eventual character. It seems to me that this is what has happened, and is still happening, to what we have all of us called "cost accounts." The name is simple and striking. It seems to convey a meaning perfectly, and even to constitute a binding definition. It is but natural if after a while cost accounts are found to have been fitted to their name; cost accounts are accounts to determine costs.

The federal trade commission has probably been one of the principal influences which have furthered among manufacturers a sense of the necessity of cost accounts, but always as far as I know to the end that they may have knowledge of the costs of their products. And a recent and not unauthoritative definition of cost accounts speaks of their sole purpose as being to state the costs of products. Nor, notwithstanding the emphasis laid constantly by practitioners of cost accounting upon the potential uses of cost accounts in attaining economy of manufacture, can one doubt that such a definition of cost accounts, as actually existing, has a wide, though of course not a universal, accuracy.

Now cost accounts originally bore another name. They were called "factory accounts." Apparently someone with an instinct for the striking word, managed to change their name, I believe with unfortunate results. The new name of "cost accounts," truly understood, is perfectly comprehensive, for all the expenses of manufacturing, from the building of a manufacturing plant to finishing the products for the market, are nothing but the costs of such products (unless, indeed, they are waste), and they are none of them ever recoverable at all except as they are recovered in the sale of the products.

But unfortunately the term "cost accounts" was liable to a narrower interpretation, and this is what has befallen it. They

became a separate and limited thing, outside of the main system of double-entry bookkeeping and for the sole purpose of arriving at cost figures.

In the year 1887 there was published a book which was for long, and I am inclined to think that it still is, the best existing book on the subject of manufacturing cost accounts. But it was not called cost accounts, nor do I think that term occurs in the whole course of it. It was written by Emil Garcke, managing director of the British Electric Traction Company, and J. M. Fells, general manager of the Salt Union, Limited. They appear to have been important industrial executives, and they were certainly accomplished accountants. The title of the book was *Factory Accounts*, and in it there was never the idea that the factory accounts were anything other than an integral part of the total system of double-entry accounting, or that they were for a single purpose, or for any limited number of specified purposes, for their many uses are considered step by step throughout the description of them. Contrast with the idea that cost accounts are for the single purpose of ascertaining costs of products even the following uses of factory accounts which are more specially dwelt upon in this book published as long ago as 1887:

(a) To give (of course) the cost of production, both by completed products and in detail;
(b) To disclose wastes and to point the ways to lowering costs;
(c) To account for materials as cash is accounted for, and to regulate them in accordance with the factory needs;
(d) To give continuous inventory figures, making frequent profit and balance-sheet statements possible;
(e) To create a moral effect upon the employees, both by their knowledge of the existence of a strict accounting and by their own participation in effecting it;
(f) To furnish a sound basis for participation by employees in profits arising from increased efficiency, binding the interests of employer and workmen more closely together.

It is possible that if we had held to the idea of factory accounts as an integral part of the balanced double-entry accounts of a manufacturer, with their unbroken chain of controlling accounts and controlled books, and had not substituted a narrower idea of "cost accounts," it might have been better. I think factory accounts is a more accurate and more useful term than cost accounts.

The next cost accounting term that I will consider is "tying in," applied to the effecting of an agreement between the figures in the cost accounts and corresponding figures in the general books. A recent important publication,* in reviewing the history of cost accounting in the United States, says "the first long step forward of progress in overhead accounting came with the appreciation that costs should be tied in with the general books."

Now "tying in" can not possibly be anything more, and I do not see how it can be anything less, than bringing the cost accounts within the double-entry system of the general accounts. As I have already said, in Garcke & Fells' book published in 1887 there is not the slightest suggestion that they shall be outside of that system, with the inevitable consequence of being unbalanced and uncontrolled. They are included in it by the simplest means. The general ledger stores account controls the materials and supplies ledgers. The manufacturing account controls the cost ledgers. The stock account controls the finished-stock ledgers. The bookkeeping principle, one might almost say the procedure, is identical with that of the controlling account and controlled ledger for accounts receivable. The "tying in" is just the same in the one case as the other, and it is nothing but simple double-entry bookkeeping. If factory bookkeeping is double-entry bookkeeping, there can be no need to talk of tying in. The cost accounts will be tied in already, quite perfectly.

And then there is the unfortunate term "overhead." This came into use but a very limited number of years ago, and seemed almost immediately to achieve a universal popularity. At present, practically, one is forced to use the term, however one rebels against it. In the original *Century Dictionary*, published about forty years ago, there was no such word in the present sense. In the *Supplement*, published about twenty years later, it appeared, defined as "average; applicable to all." Costs were then, and have been ever since, down to this very day, defined as consisting of materials, direct labor and overhead. In the pamphlet issued by the department of manufacture of the Chamber of Commerce of the United States, already referred to, it is said:

> "Overhead is usually defined in accounting text books to include the elements of cost that are left over after charging direct to a product the readily allocated materials and the labor that have been employed direct in its manufacture.

* *The Evolution of Overhead Accounting:* Department of manufacture, Chamber of Commerce of the United States.

> . . . Indirect items of cost include such things as the superintendent's salary, power, light, the cost of owning and operating buildings and machinery, and so on. Overhead is the general term applied to these indirect costs."

The Chamber of Commerce pamphlet describes how at first all this "overhead" was distributed to the different products on the basis of direct labor, money or hours, without departmentalizing expenses; how later came the departmentalization of expenses; and later still machine rates.

So far I believe it is plain that what is being considered is the machine industries. Indeed, I believe this is true of nearly all discussions of cost accounting, even to this day. As long as we assume this limitation, the methods of cost accounting advocated are intelligible, and all of them probably are still useful under the different conditions in the machine industries today. But there are other and vast industries to which such procedure seems to have little relation and often no relation whatsoever. In the paper manufacturing industries there can be no distribution of other expenses on the basis of direct labor, for labor and all other expenses of the principal part of the mill must be charged according to paper-machine time, and though this may seem virtually a machine rate it has little or no likeness to machine rates determined separately, and with much detailed distribution, to each of, perhaps, a hundred machines in a machine shop. In foundries the distribution on the basis of direct labor has a limited place and is effected with necessary modifications. In the large forging operations, it is true, there are hammer and press rates which are practically identical in character with machine-tool rates. In the metallurgical and chemical industries the procedure is quite special to the operations, and has no likeness whatever to the procedure in the mechanical industries.

On the other hand I believe the distribution and division of all expenses to "production centres" may be accepted as a universal principle, for the production centre may be the total of a factory, or a department of a factory, or a process, or a single machine, a single forging hammer or press, a single furnace of any character, a single still (as in oil refining), a single kettle (as in soap manufacturing), a group of tanks (as in electrolytic copper refining), or in fact any unit or group of units in any industrial processes.

But not all "overhead" is expense of production. Commonly a part of it, and often a considerable part, is expense of idleness.

Some little time after the publication of Hamilton Church's *Proper Distribution of the Expense Burden,** I talked on a few evenings to the students at the New York University School of Commerce and Accounts, and in those talks I dwelt long upon the importance of Mr. Church's book. But I dissented altogether from his supplementary rate by which he brought all factory expenses whatsoever into the cost of goods produced. I pointed out the imperative need of separating the expenses of what I then called "idle factory capacity," but which the present Chamber of Commerce pamphlet, contending for exactly the same thing, calls by the more convenient term of "idle facilities." The substance of what I said then was later printed as a series of articles in THE JOURNAL OF ACCOUNTANCY in the months of August, 1906, to January, 1907. This series of articles was reprinted in full in *The Accountant*, the organ of the Institute of Chartered Accountants in England and Wales, November, 1906, to February, 1907.†

"Overhead," therefore, defined as "average; applicable to all," is in large part expenses of individual production centres, costs of single processes and even of single products, as direct in their ultimate determination as the expense of materials and direct labor; and it is in varying but considerable part expense of idle facilities, and no part of the costs of any products at all. If it is doubted that the use of this word creates confused thinking, I may relate one trivial incident.

A few years ago I told a manufacturer, to whom I was talking of certain cost accounting plans as their development proceeded, that I proposed to distribute the purely general expenses of the machine shops on the basis of the combined machine rates and direct labor. He answered that it seemed to him that this would violate what he understood was "one of the first principles of cost accounting, that one must never distribute overhead on overhead." If he had used words of plain meaning and had said "You propose to distribute the purely general expenses of a machine shop on the combined cost of machine labor and men's labor," I do not think he would have gone on to the same conclusion. But instead of simple facts and actual relationships he was considering "overhead."

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* This was originally a series of articles published in the *Engineering Magazine*, July to December, 1901.

† *I see that there is a belief prevalent now that the necessity of excluding the cost of idle facilities from the cost of products, and making it a separate charge to profit and loss, was first perceived many years later (see page 1228 *Proceedings International Congress 1929*). That this is completely an error may be readily seen by reference to the articles in THE JOURNAL OF ACCOUNTANCY in the months and years above mentioned.—J. W.

The term "burden" is used now in the same sense as "overhead." They are used as absolute synonyms. All the time one comes across the expression "overhead or burden." Burden is at least a legitimate noun and consequently does not give one an immediate sense of bewilderment. In this connection it has also a different history. It originated in a period that is past, when expenses other than materials and direct labor were relatively small. Such was the state of affairs when Garcke & Fells' *Factory Accounts* was written in 1887. It is stated therein that many manufacturers were content to take out "prime cost" i. e. materials and direct labor, feeling that they could always make due allowance for the other expenses of manufacturing, without formal calculation. But "burden" and "overhead" live on together as alternative designations for the third element of cost in the machine industries. The limitation to the machine industries is my own, for it seems to me that such a limitation always exists without ever being mentioned.

I leave "overhead" and consider "burden," which is a word having a meaning that can be discussed. Is it truly expressive of the expenses of manufacturing other than labor? I believe that in many machine operations the labor might more correctly be called burden, than the power and tools by which the work is actually performed. In such operations how plain it is that the elements of cost are at least five:

Materials,
Direct labor,
Power,
Tools,
General manufacturing expense.

If these five divisions were recognized, if they had passed into the common cost-accounting speech, instead of the single paper *Accounting for Burden* in the recent international congress, we might have had at least a paper on power cost accounts and a paper on machine rates.

Then there is the word "depreciation." For what this word represents of the constant contention of accountants through the years when necessary depreciation charges were so commonly resisted, I have a great respect. Nevertheless the term is inexact, and consequently it has been a mischief-maker. Often it was difficult or impossible to contend that physical depreciation had occurred, and, even if obsolescence were considered, probably

nothing of the kind was in sight. I believe the error was a fundamental error in the view taken of manufacturing plant. It was, and I believe often is, regarded as something having an actual value in itself, whereas its only value is in its use for production. Its creation is merely the first step, the initial process, in producing marketable goods, and the proportionate cost of that initial process is as much a part of the cost of every item of the resulting production as is the cost of any later process. It would seem impossible that there could at any time have been any question that all manufacturing plant has a limited life (whether limited by its being worn out or its being superseded) and that at the end of its life its cost has been a part of the cost of all the product obtained by its use, without excepting a single item of such product, from first to last; and that consequently by a process of amortization the cost of plant must be steadily absorbed into the cost of products, and that depreciation as a fact at any given time has nothing to do with the matter. I think amortization would always have been a better word.

There is another cost-accounting term that has come into use and that seems not unlikely to achieve a popularity like that of "overhead," and this is "pre-determined costs." Pre-determined costs have been put forward as something infinitely superior to actual recorded costs. I think myself that, whatever is meant by pre-determined costs, they can not but be something so absolutely different and distinct from costs actually recorded that the two are not comparable and that there can not be superiority of one over the other. "Pre-determined costs" are presumably comparable with any other estimates, or calculations, or forecastings of costs, before actual production, and I am not questioning any claims that may be made as to their uses and values, but I do not like the term. The *Century Dictionary* gives certain varied definitions of the word pre-determine, supporting each with quotations, and, in all except one, it is not man that pre-determines, but quite another Being. The single exception is represented by a quotation from Sterne's *Sentimental Journey:* "The moment I cast my eyes upon him, I was pre-determined not to give him a single sou." Which is of course quite a different thing from pre-determining the costs of manufacture.

Concerning estimates (which is all they can be) prior to manufacture, and costs actually recorded from day to day as the manufacturing progresses, and the uses of these two sets of figures in

conjunction with each other, it would be difficult to-day to add anything of real significance to the following quotations from Garcke & Fells' book published in 1887, although one speaker at the international congress seemed to think that before 1908 there were only the dark ages.

> "Before any order to manufacture is given it is advisable, as tending to produce greater economy in cost of production, that the designer, draughtsman, or other person best acquainted with its processes and details, should, on a properly ruled and headed form, estimate the probable cost to be incurred in wages and materials in the production of the articles in question. This estimate should be a minimum rather than a maximum one. The works manager or foreman should be supplied with a complete specification of all material and parts included in the estimate. The storekeeper should also be furnished with the same particulars, and should not without special authority issue more material for the order than is estimated."
>
> "To ensure consideration of the question of what economies are practicable in construction or manufacture, the heads of the designing and manufacturing departments should be advised of the cost of each order when it is completed in such detail as permits of a comparison being instituted between the actual and estimated cost. As a matter of convenience the estimate forms may include columns for the actual costs to be inserted when known. The employer should be advised of the differences between actual and estimated costs in such detail as he may require. It is also desirable that a comparative cost register should be compiled showing the difference in cost of making the same or similar articles under differing conditions of time, material, parts, or quantities. This register will be specially serviceable in preparing estimates and quoting for orders, and permits of the necessary adjustments in quotations consequent upon the increase or decrease in the market price of material."

How simple the words, how temperate the phrasing throughout, and still I doubt whether there is any other book on factory accounts, even after this interval of 43 years, that can be read with so much profit to-day.

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[My quotations from Messrs. Garcke & Fells' book are taken from the edition of 1902. I think I can say from memory that this 1902 edition is substantially the same as the original edition of 1887.—J. W.]

# Accounting for Investment Trust Depositor Corporations

By Clay Rice Smith and Richard C. Crouch

Leland Rex Robinson in his book *Investment Trust Organization and Management* describes the contractual investment trust in the following manner:

"Investment trusts of the 'contractual' type are those existing and operating purely by reason of a contract (usually in the form of a 'trust agreement' or 'indenture') involving three parties, (1) the creator of the trust, generally known as the 'depositor,' and usually a corporation organized for the purpose of setting up investment trusts of this character and selling to the public the participations therein; (2) the 'trustee,' that is, the trust company or bank which holds the securities and/or cash, authenticating and delivering the participating certificates to the 'depositor'; and (3) the owners of the participating certificates who, by the act of buying these certificates, become *ipso facto* parties to the indenture or agreement under which they are issued."

Dr. Robinson classifies the contractual trusts under two main groups: unit series trusts and fund trusts. The unit series trusts may be fixed or supervised. The fixed trust indenture defines and prescribes the composition of the unit or the underlying securities deposited with the trustee, usually consisting of a few shares in each of many specifically designated corporations. The depositor acquires the prescribed shares in the open market and, when a unit is completed, delivers them to the trustee, who issues trust shares (usually to the number of one thousand to each unit) representing proportionate participations in the ownership of the trust assets. The depositor corporation disposes of the shares to the public, the sales customarily being effected through other dealers.

The sales or offering price of the trust shares is based primarily upon the liquidation-value of the underlying securities on the day of sale. To the liquidation value basis, however, a few other charges are customarily added: (1) a small charge to cover the costs of printing certificates and other necessary expenses, (2) the amount of dividends or other earnings accumulated to the date of sale on the underlying assets, (3) a cash reserve amount for the purpose of equalizing future distributions, and (4) a selling or underwriting commission. The trust share gives the holder a

proportionate ownership in accumulated earnings and cash reserves as well as an interest in the underlying securities and, as provided by the indenture, the right to his share of any distributions made by the trustee. The indenture may also entitle the owner of a stated number of trust shares (ordinarily one-half of a unit) to withdraw a corresponding portion of the underlying securities and accumulated earnings by presenting his trust shares to the trustee for conversion. In addition to this, the depositor corporation may maintain a market by repurchasing shares at agreed prices from holders of smaller lots than those described above.

In the fixed-unit trust no substitutions may be made in the underlying securities except those prescribed in the indenture for the purpose of protecting the principal and the earning power of the fund. Therefore, the depositor corporation acts only as creator of the trust and seller or underwriter of the authenticated trust shares and does not assume and is not permitted an extensive managerial control.

The supervised unit-series trust is created on the same general principles found in the fixed-unit type with the exception that the depositor corporation is given the right to supervise the trust assets. This right is ordinarily limited to the substitution of securities which fall within restrictions prescribed by the indenture. For this supervisory function the corporation is granted a managerial compensation usually based upon the profits earned by the trust with a minimum fee based upon a certain percentage of the total assets in the trust fund as of each ex-dividend date.

The fund trusts differ from the unit series in that the trust fund does not consist of a fixed number of shares in prescribed corporations. The fund is created by the deposit of cash and/or securities with the trustee. It is supervised by the depositor corporation which may use the cash for the purchase of securities or may sell the securities already in the fund and employ the cash so provided for the purchase of different securities. The assets of the trust are not ordinarily confined to the original funds deposited and accumulations thereon but may be increased by additional deposits of cash and/or securities and further participating shares issued against such deposits.

The shares issued by the fund trustees may be of one class, each share representing an ownership in the funds and the profits equal to that of all other shares. Or two classes may be pre-

scribed, one of par value, giving the holder a liquidation ownership in the fund up to, but not exceeding, the par value; the other of no par value, representing proportionate liquidation ownership to the amount of the fund in excess of the total par-value ownership. The par-value share customarily is given a stated yield or dividend rate while that of the no-par-value share may be discretionary or contingent.

Many other variations of ownership structure may be found in studying the contractual trusts, but most of them are subject to classification under the general groups and provisions outlined above. As indicated by the title, the scope of this article is the accounting problems peculiar to the depositor corporations which organize these trusts and distribute the authenticated shares.

Among the depositor corporations creating and underwriting fixed unit-investment trusts, items of peculiar interest center chiefly in the income accounts. The primary source of income for this type of corporation is in commissions or "spread" income on the sale of the trust shares to the public through the medium of dealers.

Another source of profit or loss to the corporation is found in the variations of market price of underlying securities between the date of purchase and the date of sale of the trust shares. Increases or decreases in the market price of underlying securities will be reflected in the offering prices of the participating shares. As the underlying securities may be purchased on dates other than the sale of the shares, amounts of profit or loss are won or suffered by the selling organization because of the market fluctuations. Many of the depositor corporations, through their perspicacity in choosing the proper moment for the purchase of these securities, will bring this source of profit into almost as important a position as that received from underwriting commissions.

As has already been noted, the depositor corporation may undertake to maintain a market through the process of repurchasing the trust shares from the individual owners. The repurchased shares may be accumulated until a sufficient number is on hand to enable the corporation to convert them into the underlying securities. These securities may then be disposed of in the open market or they may be employed in establishing a new unit at a later date. The repurchased certificates may, on the other hand, be resold through the same channels utilized for their original distribution without disturbing the underlying assets. In any

case profits or losses will arise from such transactions because of the fluctuations in the market value of the underlying securities and provision must be made for them in the accounting system.

An illustrative method for booking the income items in question is outlined below:

Stocks
  Stock brokers
To record the purchase of the underlying securities.

Trust shares
  Stocks
  Cash (for reserve for equalizing future distributions)
To record the deposit of trust assets and the receipt of trust shares from the trustee.

Accounts receivable—dealers
Dealers' commissions
  Sales of trust shares
To record sale of trust certificates.

Market fluctuations on sales
  Trust shares
To transfer cost of trust shares to a profit account.

Cost of sales
  Market fluctuations on sales
To credit market fluctuation account with the basic price, i.e. sales price less the spread between liquidation value of the trust shares at the date of sale and selling price.

The above entries record the income from commissions, dealers' commissions paid, and the profit or loss from market differences on the original sale of trust shares. The sales account less the cost of sales account reflects the "spread" income. The market fluctuation account accumulates the profits and the losses arising from differences in the price of underlying securities on the date of their purchase and the date of the sale of the trust shares.

Trust shares
  Cash
To record small lot purchases for purposes of maintaining a market on the trust shares. The bid price is an amount usually equal to or slightly higher than the liquidation value of the share.

Profit and loss on repurchases
  Trust shares
To transfer the cost of trust shares resold.

Market fluctuations on sales
  Profit and loss on repurchases
To transfer the liquidation price as of the repurchase date to a fluctuation account.

Cost of sales
  Market fluctuations on sales
To transfer the basic price on the date of resale of repurchased shares.

Accounts receivable—dealers
Dealers' commissions
  Sales of trust shares
To record the resale of the shares.

The various profits on shares repurchased and resold are accounted for according to the above summary entries. The "profit and loss on repurchases" account shows the profit realized or loss suffered by the depositor corporation because the repurchase price is greater or less than the liquidation price. This is a profit actually belonging to the period or the date at which the repurchase is made. Conservatism, however, usually persuades the corporation not to take up the profit on its records until actually realized by the resale or conversion of the certificates. Furthermore, repurchased shares are in this way carried on the books at cost rather than at a liquidation value on the date of repurchase, which is considered the most desirable by many of the companies. The other accounts are identical with those that analyze commissions and market profits on the original sale.

Profit and loss on repurchases
  Trust shares
To transfer cost of trust shares converted into underlying securities.

Market fluctuations on conversions
  Profit or loss on repurchases
To transfer the liquidating value of the trust shares on the date of repurchase. The "profit and loss on repurchases" account thus shows the profit or loss to the depositor corporation arising from the difference in the repurchase price and the liquidation price of that date.

Accounts receivable—stock brokers
  Market fluctuations on conversions
To record sale of stocks in the open market which were withdrawn from the trustee by presenting trust shares.

Should the converted securities be re-employed as underlying securities for a new unit, the entries would be the same as in a sale of trust shares based upon securities purchased in the open market, with the one difference that the cost of the securities will be taken from the "profit and loss on repurchases" account.

At the closing of the books for a statement period, there may be trust shares sold and not yet delivered or there may be commitments for the repurchase of outstanding shares which have not yet been received. These items must be properly accrued for the purpose of compiling an accurate statement. In the case of shares sold but not yet delivered, the accrual would consist of charging the cost of the underlying trust assets to the cost of sales. It sometimes happens that the underlying securities have not been purchased and in such a situation it becomes necessary to take an estimated cost based on the market price of those securities as of the closing date. The accrual for the repurchase of outstanding shares not yet received would be made by setting up the shares in an asset account at the repurchase price contracted for and crediting a properly labeled liability account.

The depositor corporations, engaged as they are in the business of underwriting and selling trust shares and of maintaining a market for those shares through repurchases, are in the usual course of events in possession of a number of those shares. The shares entitle the holder to a proportion of the distributions made by the trustee and suitable record must be made of such receipts. As a corollary to this, the corporation will usually receive all distributions not mailed directly by the trustee to the owners and the corporation is thus charged with accounting for these distributions. Such items not distributed must be carried, of course, as dividends payable.

Another source of income enjoyed by some depositors is interest on the reserve fund deposited with the trustee for the purpose of equalizing future dividend payments or for other purposes. Further interest income to the corporation on undistributed earnings accumulated in the trust is proscribed by some indentures. Another common provision is that the depositor retain the voting power attached to the ownership of the underlying securities held by the trustee. Such provisions make a system of close surveillance of the trust assets of particular importance and the records of the depositor should be organized with that purpose in view.

Stock split-ups, stock dividends and rights to subscribe on securities held in the trust are sometimes disposed of immediately and the proceeds paid out to the shareholders at the regular dividend-payable date. The depositor corporation, as a shareholder, receives its portion of such distributions. It is considered by some companies that these receipts should be credited to the asset value on the books because, they say, the cost of the trust shares represents the price of ownership of the underlying securities whose market value is diluted by the issue of stock dividends or "rights" to subscribe. Others contend that the proceeds are income, and some follow the federal income-tax regulations on the treatment of the profits from such transactions. It is not, however, the purpose of this article to enter into a discussion of this problem.

In addition to the types of income already listed, the depositor corporations of supervised trusts of either the unit series or the fund type are allowed a managerial fee for their services in substituting stocks and otherwise managing the fund. This income must, of course, be provided for by a proper income account.

As previously stated, the depositor corporations may at any given time have possession of some of the trust certificates which they underwrite and sell. This, of course, is the inventory of the stock-in-trade and as such presents the problem of valuation for statement purposes. Obviously the corporation may qualify as a dealer in such securities and therefore may value its inventory for federal income-tax purposes in accordance with article 105 of regulation 74 issued by the commissioner of internal revenue:

> "The dealer in securities who in his books of account regularly inventories unsold securities on hand either (a) at cost, (b) at cost or market, whichever is lower, or (c) at market value may make his return upon the basis upon which his accounts are kept."

Some of the corporations value their certificates for inventory purposes at cost, while others value them at cost or market, whichever is lower. The authors are not acquainted with any corporation that makes use of the straight market valuation, although that method of valuing security holdings of investment trusts is recommended by some writers. Cost of the shares withdrawn from the trustee on the original deposit and issue, but not yet sold to the public, would consist of a proportionate part of the

cost of the underlying securities and the cash reserve deposited. The market value would be at the price offered to small lot shareholders for purposes of market maintenance. This market price is in accord with article 104 of the regulations which says:

> "Market means the current bid price prevailing at the date of inventory for the particular merchandise in the volume usually purchased by the taxpayer."

For shares repurchased from small lot holders, cost would consist of the actual amount expended therefor, while market would be identical with that described above.

The federal income-tax law presents another feature which is of importance to the accounting procedure of depositor corporations. Although organized as trusts, they may be classed as such for income-tax purposes or they may be considered to be associations and therefore taxable in the same manner as corporations. The criterion for such distinction lies in the degree of managerial control exercised over the assets by the trustees or beneficiaries. It is generally conceded that fixed-unit trusts, not being subject to extensive control by either trustee, depositor or beneficiary, may qualify as pure trusts for tax purposes, while the supervised unit trusts and the fund trusts are considered to be associations, because of the degree of management of the assets exercised by the depositor corporation.

The fixed unit trusts usually credit earnings for the period to the beneficiaries, and they must, therefore, under taxation provisions for trusts, take up their proportionate share of the income, whether or not distributed by the trustee. The depositor corporation, as a holder of certificates, usually accrues earnings as reported by the trustee, and divides it on his income records as to dividends, profits on substitutions, and to any other type of income which may occur. The asset side of this accrual is usually carried in a receivable account with the trustee and any income distributed or the accumulated earnings included in the sale of the shares in question are credited to this account.

The supervised unit and fund trusts are generally considered to be taxable as corporations, and the beneficiaries, therefore, take up the distributions as dividends. Consequently, the usual custom of the depositor corporations is to take the distributions into the income accounts as dividends when received from the trustee, and the income of the trust is not accrued as in the case of the fixed-unit depositor.

The fund trust depositor corporation will sometimes receive compensation for managerial services through the medium of a prescribed proportion of the total no-par-value shares issued in each fund. Under such agreements, the customary procedure is to book these shares so received at a nominal value or at no value in the case of the first issue and on later issues at the amounts paid in for each such share. The amounts so recorded are credited to income as management commissions. The method is illustrated by the following hypothetical example.

Funds and securities totaling five thousand dollars are deposited with the trustee. The trustee issues 500 class A shares and 550 class B shares. The class A shares have a par value of $10 and one A and one B share are sold to the public for that amount. The fifty B shares are given to the depositor corporation as management compensation. As nothing is paid into the fund for the B shares the depositor corporation takes them up at a nominal value or at no value on the books. As the fund increases, because of profits on sales, dividends and appreciation in the market value of unsold securities, the B shares will attain an equity in the assets of the trust and will also receive any distributions allowable by the indenture. Subsequently, the management may decide to increase the funds by depositing additional securities and/or cash and having another block of the same number of trust shares issued. In order that the shareholders of the first issue may not suffer a shrinkage in their equity, the new deposit must equal the total liquidating value of the underlying assets already in the fund as of the date of the second issue. Consequently the new amount deposited will equal $5,000, the par value of the first issue of class A shares plus the excess of the present fund over that amount, for example $5,500, making a total to be deposited of $10,500 or the present value of the original fund. Five hundred A shares and 550 B shares will be issued as before and the 500 A shares and 500 of the B shares will be sold to the public for $10,500. The other fifty B shares will again be retained by the depositor corporation. The booking value of the shares retained will be determined by dividing the $5,500 excess paid in by the 550 shares issued therefor or $10 per share. The class B trust shares account will be charged with its $500 equity in the trust fund, and management income will be credited.

Another variation of the principle of paying the management commission through the medium of trust shares is permitting to

the depositor corporation a privileged subscription at less than the offering price on class B shares. In this situation, as in other arrangements, the proper booking procedure is to charge the share accounts with its equity in the trust fund at the time of the issue of the trust shares and to credit income with any excess over amount of cash paid therefor.

As in accounting for any other type of business, books of original entry and ledgers must be provided which will most efficiently record the transactions involved. The provisions in the indenture and other such circumstances will necessarily cause the problems encountered by different corporations to vary and no system of ledgers and journals can be prescribed to fit all cases. It usually will be found, however, that the following records will be necessary: general ledger, cash and security blotters, repurchase ledgers, security ledgers, general journal, sales registers, stock position, cost of unit record, accounts-receivable ledger, commission ledger and trust-account ledgers.

# Accounting for Naval Stores Producers

By C. Weis

It has been the author's observation that few naval-stores operators keep accurate cost records, or accurate records of any kind. This perhaps is because many of them operate on small capital and their employees have not the proper conception of the value of adequate accounting records. The large producers at first, in many cases, operated also on small margins and carelessness in handling their records is the result of practices of earlier years.

It is the purpose of this paper to submit only brief comments on accounting peculiar to the naval-stores industry, with conclusions based on the author's own experience and upon principles accepted by the internal-revenue department in the computation of net income for income-tax purposes.

Determining the amount of depletion of turpentine leases and depreciation of physical properties presents problems that require a thorough analysis of the cost of these items, together with other factors bearing thereon, if amortization is to be scientifically handled. Proper valuation of inventories is utterly impossible unless necessary cost records are maintained. In many cases, inadequacy of the records compels the internal-revenue department to resort to arbitrary assessments of income tax which often result unfavorably to the taxpayer, inasmuch as complete evidence is not available upon which to base the computation of the tax.

Naval-stores producers usually lease the timber which they operate, though in some cases it is purchased outright. The most common leases are those extending over a period of three or four years from the date of cupping, the cost being based on a certain sum per thousand cups or boxes hung—10,000 boxes being considered a crop. In leasing timber it is customary for the lessee to make an initial payment to the lessor, thereby binding the contract, the balance being payable when the cupping is completed and the boxes counted. Where the timber is bought outright, a large part of the cost is applied to turpentine rights, that being the primary object of the purchase. On leases extending

over a three-year period, the internal-revenue department has agreed in various cases that 45% of the annual crop (valued as shown hereafter) may be charged off the first year; 35% the second year; and 20% the third year. On four-year leases, rates of 35%, 25%, 20% and 20% have been accepted by the department. In order, however, to secure these deductions in preparing income-tax returns, it is evident that taxpayers must provide the necessary information, for submission to the department, through the maintenance of proper accounting records.

All initial lease payments may be charged to one account pending the cupping of the timber and the ascertainment of the total cost. When final payment is made on a lease, this final payment, together with the initial payment, should be charged to an account captioned to designate the class of lease, such as "three-year leases," "four-year leases," etc., together with the number of boxes put up. With this information, computation of the amount to be charged off as depletion is comparatively simple. It may be illustrated on a full crop basis as follows, assuming that at the beginning of the period 8.78 full crops were being operated and that the leases extend over a four-year period:

| | Full crops | Amount | Average per crop |
|---|---|---|---|
| Balance at beginning of year.......... | 8.78 | $15,508.83 | $1,758.39 |
| Boxed during year (48,787 boxes hung) | 4.88 | 7,406.97 | 1,517.90 |
| Totals.......................... | 13.66 | $22,915.80 | $1,677.58 |
| Depletion for current year............ | 6.66 | 11,172.68 | 1,677.58 |
| Balance at close of year.......... | 7.00 | $11,743.12 | $1,677.58 |

The balance of 8.78 full crops at the beginning of the year is represented by the following:

| | |
|---|---|
| 7.26 crops of yearling (2d year working) at 65%................ | 4.72 |
| 4.65 crops of buck (3d year working) at 40%.................... | 1.86 |
| 11.00 crops of pulling (4th year working) at 20%.................. | 2.20 |
| Total full crops.......................................... | 8.78 |

It is clear, then, that the depletion, in full crops, to be charged off for the year is readily determined from the data as

follows, being based on the actual number of crops of boxes in operation:

| | |
|---|---|
| 4.88 crops of virgin (1st year working) at 35% | 1.71 |
| 7.26 crops of yearling (2d year working) at 25% | 1.82 |
| 4.65 crops of buck (3d year working) at 20% | .93 |
| 11.00 crops of pulling (4th year working) at 20% | 2.20 |
| Total full crops worked | 6.66 |

Inasmuch as the lease on the eleven crops of pulling expires with the fourth year's working, this item entirely disappears in the following year's operations; the 4.65 crops of buck become pulling; the 7.26 crops of yearling become buck; and the 4.88 crops of virgin become yearling. From this we determine that the 7.00 full crops at the close of the year is represented by the following:

| | |
|---|---|
| 4.88 crops of yearling (2d year working) at 65% | 3.17 |
| 7.26 crops of buck (3d year working) at 40% | 2.90 |
| 4.65 crops of pulling (4th year working) at 20% | .93 |
| Total full crops | 7.00 |

If an original purchase is made from another operator and if it includes leases that have been partly worked out, these may be reduced to a full-crop basis, as follows, assuming, for example, the purchase includes eleven crops of boxes that have been worked one year, three crops that have been worked two years and six crops that have been worked three years:

| | |
|---|---|
| 11 crops of yearling at 65% | 7.15 |
| 3 crops of buck at 40% | 1.20 |
| 6 crops of pulling at 20% | 1.20 |
| Total full crops | 9.55 |

The average cost of the leases worked is ascertained by using the unamortized portion of cost at the beginning of the year, plus the cost of leases boxed during the year, divided by the number of full crops, as shown in the first table above.

It often happens that, after a lease has expired, the land is re-leased for one or two years. In such cases, the additional cost may be charged off equally over the re-lease period.

The physical properties of naval stores producers consist principally of temporary cabins for laborers; galvanized cups and aprons for boxing the timber; trucks and live stock for transporting crude gum to the still; still and equipment; office building and commissary; telephone lines; and tools. When an operation is completed, these assets have practically no salvage value, and, consequently, their entire cost should be written off during the life of the operation on an equitable basis. While a number of operators use a straight-line rate of depreciation, this is neither equitable from an accounting point of view nor for federal income-tax purposes. Approximately three-quarters of the money invested in physical properties is used for laborers' cabins and cups and aprons, none of which has any value when the turpentine leases have expired. Even though adjoining timber may be leased, a new supply of cups and aprons would have to be purchased and additional cabins constructed. In order, therefore, to equalize the depreciation, a crop working basis should be used. Assuming, for purposes of illustration, that an operator purchased from another producer unexpired leases on twenty crops of boxes, of which eleven crops had been worked one year; three crops had been worked two years; and six crops had been worked three years; and, in addition purchased from various parties, leases for 4.65 crops, none of which had been boxed, the number of crop workings would be determined as follows:

| | Virgin | Yearling | Buck | Pulling | Totals |
|---|---|---|---|---|---|
| For 1st year working..... | 4.65 | 11 | 3 | 6 | 24.65 |
| For 2d year working ..... | | 4.65 | 11 | 3 | 18.65 |
| For 3d year working...... | | | 4.65 | 11 | 15.65 |
| For 4th year working..... | | | | 4.65 | 4.65 |
| Total crop workings.. | 4.65 | 15.65 | 18.65 | 24.65 | 63.60 |

Assuming further, then, that the total cost of the physical properties was $28,000, depreciation for the first year would be ascertained as follows:

| | Amount | Crop workings | Average per crop |
|---|---|---|---|
| Total cost, crop workings and average | $28,000.00 | 63.60 | $440.25 |
| Depreciation—first year............. | 10,852.16 | 24.65 | 440.25 |
| Balance at close of year......... | $17,147.84 | 38.95 | $440.25 |

The average of \$440.25 is found by dividing the total cost of the properties, \$28,000, by the total number of crop workings, 63.60, and this average multiplied by the number of crops worked during the year, 24.65, determines a depreciation charge of \$10,-852.16. Before computing depreciation for the second year, additions to the properties and additional lease purchases, reduced to crop workings, will be added to the balances and the computation repeated, and so on for subsequent years.

The proper valuation of inventories of a naval-stores producer is a question deserving much attention, particularly when the quantities unsold are substantial. The production consists of spirits of turpentine, rosin and dross, all of which are obtained from the same material (crude gum) and are manufactured in the same process. Dross being a by-product, as in other manufacturing enterprises, its value may be deducted from the total manufacturing cost, and the remaining cost segregated between the other two commodities on basis of the value of each, illustrated in the following manner, assuming that the cost to be segregated is \$71,005.23:

| | Value of production | | Cost of | Barrels | Average cost |
|---|---|---|---|---|---|
| | Amount | % of total | production | produced | per barrel |
| Spirits of turpentine | \$ 35,819.67 | 34.09 | \$24,205.58 | 1,695 | \$14.28 |
| Rosin. . . . . . . . . . . | 9,252.96 | 65.91 | 46,799.65 | 5,857 | 7.990 |
| Totals. . . . . . . | \$105,072.63 | 100.00 | \$71,005.23 | 7,552 | \$ 9.40 |

The above value of production, \$105,072.63, is ascertained by using the net proceeds of sales of the portion of each commodity sold, plus the market value of the inventory at the closing date, calculated by grades. The percentage that each bears to the total value of the production is found, and the percentages are applied to the total cost as segregated in column three. Having found the number of barrels produced of each commodity, the average cost per barrel is readily determined. These average costs may then be used for inventory purposes, a method of valuation which has been accepted by the internal-revenue department as being in accordance with section 205 of the revenue act of 1926, article 1617 of regulations 69.

The form of cost-and-yield statement on the following page has been found excellent for practical purposes, especially in comparing one year with another or in comparing one operation with another.

| *Explanation* | Year | Year | Increase *Decrease* |
|---|---|---|---|
| Barrels of crude gum stilled. . . . . . . . . . . . . . . . | | | |
| Average cost per barrel: . . . . . . . . . . . . . . . . . . | | | |
| Labor. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Barrels, heads, staves, etc. . . . . . . . . . . . . . . | | | |
| Other supplies. . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Truck expenses. . . . . . . . . . . . . . . . . . . . . . . | | | |
| Stable expenses. . . . . . . . . . . . . . . . . . . . . . . | | | |
| Repairs. . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Still expenses. . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Total manufacturing expenses. . . . . . . . . . | | | |
| Depletion of turpentine leases. . . . . . . . . . . . | | | |
| Depreciation of equipment. . . . . . . . . . . . . . | | | |
| General expenses. . . . . . . . . . . . . . . . . . . . . . | | | |
| Total manufacturing cost. . . . . . . . . . . . . . | | | |
| Average yield per barrel—in gallons: | | | |
| Spirits of turpentine. . . . . . . . . . . . . . . . . . . | | | |
| Average yield per barrel—in pounds: | | | |
| Spirits of turpentine. . . . . . . . . . . . . . . . . . . | | | |
| Rosin. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Dross. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Total yield. . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Waste. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Total weight per barrel. . . . . . . . . . . . . . . | | | |
| Average yield per barrel—in barrels: | | | |
| Spirits of turpentine. . . . . . . . . . . . . . . . . . . | | | |
| Rosin. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Dross. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Total yield. . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Waste. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Totals. . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Production in barrels: | | | |
| Spirits of turpentine. . . . . . . . . . . . . . . . . . . | | | |
| Rosin. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Dross. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Total production. . . . . . . . . . . . . . . . . . . . | | | |
| Waste. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | |
| Total crude gum. . . . . . . . . . . . . . . . . . . . | | | |

| | Year | Year | Increase *Decrease* |
|---|---|---|---|
| Percentage of waste | | | |
| Number of crops in operation | | | |
| Average production per crop—barrels: | | | |
| Crude gum | | | |
| Spirits of turpentine | | | |
| Rosin | | | |
| Dross | | | |
| Average cost of finished product per barrel: | | | |
| Spirits of turpentine | | | |
| Rosin | | | |
| Number of men employed | | | |

The average costs in this statement are based on a barrel of crude gum, but some operators use five barrels of crude gum as a unit of cost. This is done because it usually requires five barrels of gum to produce one barrel (50 gallons) of spirits of turpentine, with approximately three and one-third barrels (500 pounds per barrel) of rosin and about 100 pounds of dross.

The methods outlined in this article have been used to advantage by the author in actual practice and have been found acceptable by the internal-revenue department for income-tax purposes.

# Students' Department

H. P. BAUMANN, *Editor*

## AMERICAN INSTITUTE EXAMINATIONS

[NOTE.—The fact that these answers appear in THE JOURNAL OF ACCOUNTANCY should not cause the reader to assume that they are the official answers of the board of examiners. They represent merely the opinions of the editor of the *Students' Department.*]

### EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART II

May 16, 1930, 1 P. M. to 6 P. M.

*The candidate must answer all the following questions:*

No. 1 (25 points):

Following are the balance-sheets of companies M and N as at December 31, 1929:

COMPANY M

*Assets*

| | | |
|---|---|---|
| Current: | | |
| Cash | $ 50,000 | |
| Accounts receivable—customers | 800,000 | |
| " " —N company | 100,000 | |
| Inventories | 480,000 | |
| | | $1,430,000 |
| Fixed—less reserve for depreciation | | 3,500,000 |
| Investment in N company (Cost of 3,800 shares of preferred and 23,520 shares of common stock, acquired July 1, 1929) | | 800,000 |
| Prepaid expenses | | 20,000 |
| Goodwill | | 1,000,000 |
| | | $6,750,000 |

*Liabilities*

| | | |
|---|---|---|
| Current: | | |
| Notes payable | $ 400,000 | |
| Accounts " | 200,000 | |
| Dividends " | 105,000 | |
| Accruals | 45,000 | |
| | | $ 750,000 |
| Funded debt: | | |
| First-mortgage bonds | | 2,000,000 |
| Capital stock: | | |
| Preferred—6 per cent. cumulative, 10,000 shares of $100 each | 1,000,000 | |
| Common—30,000 shares, no par value | 2,500,000 | |
| | | 3,500,000 |
| Surplus | | 500,000 |
| | | $6,750,000 |

COMPANY N

*Assets*

| | | |
|---|---|---|
| Current: | | |
| Cash | $ 15,000 | |
| Accounts receivable—customers | 300,000 | |
| Inventories | 150,000 | |
| | | $ 465,000 |
| Fixed—less reserve for depreciation | | 800,000 |
| Prepaid expenses | | 5,000 |
| Goodwill | | 250,000 |
| | | $1,520,000 |

*Liabilities*

| | | |
|---|---|---|
| Current: | | |
| Notes payable | $ 100,000 | |
| Accounts " | 150,000 | |
| Dividends " | 29,000 | |
| Accruals | 21,000 | |
| | | $ 300,000 |
| Funded debt: | | |
| Serial gold notes | | 400,000 |
| Capital stock: | | |
| Preferred—4,000 shares, no par value; cumulative dividends of $5 per share, per annum | 300,000 | |
| Common—24,000 shares, no par value | 400,000 | |
| | | 700,000 |
| Surplus | | 120,000 |
| | | $1,520,000 |

Particulars of the surplus accounts of the respective companies are shown as follows:

COMPANY M

| | | | |
|---|---|---|---|
| 1929 | | | |
| Jan. 1 | Balance | | $345,250 |
| Mar. 31 | Preferred dividend, March quarter | $ 15,000 | |
| June 30 | Net income for the half year | | 120,000 |
| | Dividends—preferred, June quarter | 15,000 | |
| | " —common, half year | 90,000 | |
| Sept. 30 | Preferred dividend, September quarter | 15,000 | |
| Oct. 15 | Dividend received on N company preferred stock for quarter ended September 30th | | 4,750 |
| Dec. 31 | Net income for the half year | | 270,000 |
| | Dividends—preferred, December quarter | 15,000 | |
| | " —common, half year | 90,000 | |
| | Balance down | 500,000 | |
| | | $740,000 | $740,000 |
| 1930 | | | |
| Jan. 1 | Balance | | $500,000 |

COMPANY N

| | | | |
|---|---|---|---|
| 1929 | | | |
| Jan. 1 | Balance | | $ 44,000 |
| Mar. 31 | Preferred dividend, March quarter | $ 5,000 | |
| June 30 | Net loss for the half year | 50,000 | |
| | Preferred dividend, June quarter | 5,000 | |
| Sept. 30 | " " September quarter | 5,000 | |

| | | | | |
|---|---|---|---|---|
| Dec. | 15 | Increase in appraisal of fixed assets........ | | $90,000 |
| | 31 | Net income for the half year.............. | | 80,000 |
| | | Dividends—preferred, December quarter.... | $ 5,000 | |
| | | " —common stock................ | 24,000 | |
| | | Balance down.......................... | 120,000 | |
| | | | $214,000 | $214,000 |
| 1930 | | | | |
| Jan. | 1 | Balance.............................. | | $120,000 |

From the foregoing, you are required to prepare a consolidated balance-sheet, as at December 31, 1929.

*Solution:*

Since the holding company (M company) is carrying its investment in the capital stock of N company at cost, the dividends declared by the latter company as of December 31, 1929, should be credited to surplus account rather than to the investment account.

*Adjustment 1*

| | | |
|---|---|---|
| Dividends receivable.............................. | $ 28,270 | |
| Surplus—M company......................... | | $ 28,270 |

To record the dividends receivable by M company on its investment in N company (declared December 31, 1929)

| | |
|---|---|
| Preferred—95% of $5,000.......... | $ 4,750 |
| Common—98% of $24,000......... | 23,520 |
| Total | $28,270 |

The increase in appraisal of fixed assets credited to surplus account by N company should be set out in a separate account.

*Adjustment 2*

| | | |
|---|---|---|
| Surplus........................................ | $ 90,000 | |
| Surplus arising from appraisal of fixed assets..... | | $ 90,000 |

To transfer increase or appraisal of fixed assets to a separate account.

It is assumed that the $100,000 which M company shows as due from N company had been taken up by the latter company, and is included among the accounts payable. This inter-company account should be eliminated.

*Elimination (a)*

| | | |
|---|---|---|
| Accounts payable............................... | $100,000 | |
| Accounts receivable—N company.............. | | $100,000 |

To eliminate the inter-company accounts.

*Elimination (b)*

| | | |
|---|---|---|
| Dividends payable.............................. | $ 28,270 | |
| Dividends receivable.......................... | | $ 28,270 |

To eliminate the dividends receivable by M company from N company.

*Elimination (c)*

| | | |
|---|---|---|
| N company—preferred stock | $285,000 | |
| Investment in N company | | $285,000 |
| To eliminate 95% (3,800 shares of its issue of 4,000 shares) of the book value of the preferred stock of N company. | | |

*Elimination (d)*

| | | |
|---|---|---|
| N company—common stock | $392,000 | |
| Investment in N company | | $392,000 |
| To eliminate 98% (23,520 shares of the issue of 24,000 shares) of the stated value of the common stock of N company. | | |

The surplus account of N company at the date of acquisition by M company (July 1, 1929), showed a deficit of $16,000, as follows:

| 1929 | | | |
|---|---|---|---|
| Jan. 1 | Balance | | $ 44,000 |
| Mar. 31 | Preferred dividend, March quarter | $ 5,000 | |
| June 30 | Net loss for the half year | 50,000 | |
| | Preferred dividend, June quarter | 5,000 | |
| | Deficit | | 16,000 |
| | Total | $ 60,000 | $ 60,000 |

*Elimination (e)*

| | | |
|---|---|---|
| Investment in N company | $ 15,680 | |
| N company—surplus | | $ 15,680 |
| To eliminate 98% of the deficit of N company at date of acquisition. | | |

Although the increase in appraisal of fixed assets of N company was not entered until December 15, 1929, it seems reasonable to assume that these assets were understated at July 1, 1929, the date of acquisition.

The goodwill arising from consolidation is, therefore, reduced by the amount of the surplus arising from the appraisal.

*Elimination (f)*

| | | |
|---|---|---|
| Surplus arising from appraisal | $ 88,200 | |
| Goodwill | | $ 88,200 |
| To write off the holding company's interest (98% of $90,000) in the increase on the appraisal of the fixed assets of N company. | | |

Company M, and Its Subsidiary, Company N
Consolidated balance-sheet—December 31, 1929

*Assets*

| | | |
|---|---|---|
| Current Assets: | | |
| Cash | $ 65,000 | |
| Accounts receivable | 1,100,000 | |
| Inventories | 630,000 | $1,795,000 |

COMPANY M AND ITS SUBSIDIARY, COMPANY N
Consolidated balance-sheet—working papers December 31, 1929

| *Assets* | Company M | Company N | Adjustments Dr. | Adjustments Cr. | Eliminations Dr. | Eliminations Cr. | Consolidated Balance-sheet |
|---|---|---|---|---|---|---|---|
| Cash | $ 50,000 | $ 15,000 | | | | | $ 65,000 |
| Accounts receivable—customers | 800,000 | 300,000 | | | | | 1,100,000 |
| Accounts receivable—N company | 100,000 | | | | | (a) $100,000 | |
| Inventories | 480,000 | 150,000 | | | | | 630,000 |
| Fixed—less reserve for depreciation | 3,500,000 | 800,000 | | | | | 4,300,000 |
| Investment in N company | 800,000 | | | | | | |
| Eliminate book value: | | | | | | | |
| Preferred capital stock—95% of $300,000 | | | | | | (c) 285,000 | |
| Common capital stock—98% of $400,000 | | | | | | (d) 392,000 | |
| Surplus—98% of $16,000 | | | | | (e) $ 15,680 | | |
| Goodwill | | | | | | (f) 88,210 | 50,480 (GW) |
| Prepaid expenses | 20,000 | 5,000 | | | | | 25,000 |
| Goodwill | 1,000,000 | 250,000 | | | | | 1,250,000 |
| Dividends receivable | | | (1) $ 28,270 | | | (b) 28,270 | |
| | $6,750,000 | $1,520,000 | | | | | $7,420,480 |
| Notes payable | $ 400,000 | $ 100,000 | | | | | $ 500,000 |
| Accounts payable | 200,000 | 150,000 | | | (a) 100,000 | | 250,000 |
| Dividends payable | 105,000 | 29,000 | | | (b) 28,270 | | 105,730 |
| Accruals | 45,000 | 21,000 | | | | | 66,000 |
| Funded debt: first-mortgage bonds | 2,000,000 | | | | | | 2,000,000 |
| Funded debt: serial gold notes | | 400,000 | | | | | 400,000 |
| Capital stock: | | | | | | | |
| M company: | | | | | | | |
| Preferred—6%, cumulative, 10,000 shares at $100 each | 1,000,000 | | | | | | 1,000,000 |
| Common—30,000 shares, no par value | 2,500,000 | | | | | | 2,500,000 |
| N company: | | | | | | | |
| Preferred—4,000 shares, no par value; cumulative dividends of $5.00 per share, per annum | | 300,000 | | | | | |
| Eliminate holding company's 95% | | | | | (c) 285,000 | | |
| Minority 5% | | | | | | | 15,000 (M) |
| Common—24,000 shares, no par value | | 400,000 | | | | | |
| Eliminate holding companies 98% | | | | | (d) 392,000 | | |
| Minority 2% | | | | | | | 8,000 (M) |
| Surplus—M company | 500,000 | | | (1) $ 28,270 | | | 528,270 (S) |
| Surplus—N Company | | 120,000 | (2) 90,000 | | | | |
| Eliminate holding company's 98% of $16,000 deficit at acquisition | | | | | | (e) 15,680 | |
| Minority interest 2% of present surplus | | | | | | | 600 (M) |
| Surplus—98% of $46,000 increase | | | | | | | 45,080 (S) |
| Surplus arising from appraisal | | | | (2) 90,000 | (f) 88,200 | | |
| Minority interest 2% | | | | | | | 1,800 |
| | $6,750,000 | $1,520,000 | $118,270 | $118,270 | $909,150 | $909,150 | $7,420,480 |

| | | | |
|---|---|---|---|
| Prepaid expenses | | | $ 25,000 |
| Fixed assets—less reserves for depreciation | | | 4,300,000 |
| Goodwill | | | 1,300,480 |
| | | | $7,420,480 |

*Liabilities and net worth*

| | | | |
|---|---|---|---|
| Current liabilities: | | | |
| Notes payable | | $ 500,000 | |
| Accounts payable | | 250,000 | |
| Dividends payable | | 105,730 | |
| Accruals | | 66,000 | $ 921,730 |
| Funded debt: | | | |
| First mortgage bonds | | $2,000,000 | |
| Serial gold notes | | 400,000 | 2,400,000 |
| Minority interest in Company N: | | | |
| Capital stock: | | | |
| Preferred | $ 15,000 | | |
| Common | 8,000 | $ 23,000 | |
| Surplus | | 600 | |
| Surplus arising from appraisal | | 1,800 | 25,400 |
| Net worth: | | | |
| Capital stock: | | | |
| Preferred—6% cumulative, 10,000 shares of $100 each | $1,000,000 | | |
| Common—30,000 shares, no par value | 2,500,000 | $3,500,000 | |
| Surplus | | 573,350 | 4,073,350 |
| | | | $7,420,480 |

No. 2 (10 points):

On January 1, 1915, the H J Corporation sold to a broker $300,000 (face value) of its 5 per cent. bonds at 92½ net, receiving cash therefor.

The bonds contained a clause permitting the H J Corporation to call bonds on December 31st of each year, beginning December 31, 1918, but not more than $40,000 (face value) of bonds could be called in any one year and provision was to be made for the payment of all remaining unredeemed bonds on December 31, 1929.

Bonds are called as follows:

| | |
|---|---|
| December 31, 1918 | $25,000 (face value) |
| " " 1919 | 25,000 " " |
| " " 1921 | 35,000 " " |
| " " 1922 | 20,000 " " |

| | |
|---|---|
| December 31, 1925 . . . . . . . . . . . . . . . . . . . . . . | $40,000 (face value) |
| " " 1926 . . . . . . . . . . . . . . . . . . . . . . | 10,000 " " |
| " " 1928 . . . . . . . . . . . . . . . . . . . . . . | 40,000 " " |

Formulate an account for the discount on bonds, setting forth therein the credits at December 31st of each year for charges made to the income account of the corporation from 1915 to 1929.

*Solution:*

The bond discount expense to be amortized is:

| | |
|---|---|
| Face value of bonds . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | $300,000 |
| Cash received—(bonds sold at 92½) . . . . . . . . . . . . . . . . . | 277,500 |
| Bond discount . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | $ 22,500 |

If none of the bonds were called during the fifteen-year period, this discount could be written off as an expense in 15 annual equal instalments of $1,375 each. However, the issuing company has the privilege to call and redeem on December 31st of each year, beginning December 31, 1918, up to $40,000, of the face value of these bonds. The company availed itself of this privilege in certain years.

It will be necessary, therefore, to:

(1) Compute the annual charge to bond discount expense which amount would be:

$$\frac{\text{Bond discount (\$22,500)}}{\text{Bonds outstanding (300,000)}} \text{ divided by life of bonds (15 years)}$$

or .005 of the bonds outstanding each year.

(2) Compute the unamortized bond discount applicable to the bonds called and redeemed each year, which amount should be charged to surplus. As the annual charge to bond discount expense is .005 of the bonds outstanding, the amount to be written off to surplus at the time any bonds are called and redeemed is:

.005 of the unexpired life times the face value of the bonds redeemed. Applying this formula to the $25,000 of bonds redeemed on December 31, 1918, we have

.005 x 11 x $25,000 or $1,375.

THE H J CORPORATION

Bond-discount account from January 1, 1915, to December 31, 1929

| Date | | | Bonds outstanding | Bond discount expense | Surplus (bond discount applicable to bonds redeemed) | Credit to bond discount account | Balance bond discount account |
|---|---|---|---|---|---|---|---|
| Jan. | 1, | 1915 | | | | | $22,500 |
| Dec. | 31, | 1915 | $300,000 | $ 1,500 | | $ 1,500 | 21,000 |
| " | " | 1916 | 300,000 | 1,500 | | 1,500 | 19,500 |
| " | " | 1917 | 300,000 | 1,500 | | 1,500 | 18,000 |
| " | " | 1918 | 300,000 | 1,500 | $ 1,375 | 2,875 | 15,125 |
| " | " | 1919 | 275,000 | 1,375 | 1,250 | 2,625 | 12,500 |
| " | " | 1920 | 250,000 | 1,250 | | 1,250 | 11,250 |

| | | | | | |
|---|---|---|---|---|---|
| Dec. 31, 1921 | $250,000 | $1,250 | $1,400 | $2,650 | $8,600 |
| " " 1922 | 215,000 | 1,075 | 700 | 1,775 | 6,825 |
| " " 1923 | 195,000 | 975 | | 975 | 5,850 |
| " " 1924 | 195,000 | 975 | | 975 | 4,875 |
| " " 1925 | 195,000 | 975 | 800 | 1,775 | 3,100 |
| " " 1926 | 155,000 | 775 | 150 | 925 | 2,175 |
| " " 1927 | 145,000 | 725 | | 725 | 1,450 |
| " " 1928 | 145,000 | 725 | 200 | 925 | 525 |
| " " 1929 | 105,000 | 525 | | 525 | |
| Totals | | $16,625 | $5,875 | $22,500 | |

No. 3 (30 points):

From the following trial balances of the Standard Products Company, Inc., prepare balance-sheet as at December 31, 1929, and income and profit-and-loss account for the year ended December 31, 1929, after setting up reserve for 1929 federal income tax. Also prepare a statement of cash receipts and disbursements for the year ended December 31, 1929:

| | January 1, 1929 | | December 31, 1929 | |
|---|---|---|---|---|
| Cash | $ 52,349.12 | | $ 22,383.37 | |
| Accounts receivable—trade | 155,036.45 | | 262,274.43 | |
| Inventories | 95,024.20 | | 110,096.70 | |
| Investments | 100,000.00 | | 100,000.00 | |
| Life-insurance policies—cash surrender value | 5,605.20 | | 7,675.70 | |
| Land and buildings | 285,000.00 | | 635,000.00 | |
| Vouchers payable (expenses) | | $ 6,026.12 | | $ 15,940.50 |
| Accounts payable—trade | | 82,030.78 | | 201,783.97 |
| Purchase-money mortgage, payable June 30, 1934 | | | | 100,000.00 |
| Reserve for depreciation | | 75,000.00 | | 87,500.00 |
| Capital stock 7% preferred | | 100,000.00 | | 100,000.00 |
| Capital stock—common | | 200,000.00 | | 200,000.00 |
| Surplus | | 229,958.07 | | 422,958.07 |
| Sales | | | | 542,768.40 |
| Interest on investments | | | | 5,000.00 |
| Cost of merchandise (see note) | | | 1,134,964.90 | |
| Returns and allowances—sales | | | 15,470.92 | |
| Returns and allowances—purchases | | | | 8,742.50 |
| Selling, general and administrative expenses | | | 387,547.92 | |
| Interest paid | | | 3,000.00 | |
| Life insurance | | | 6,279.50 | |
| | $693,014.97 | $693,014.97 | $2,684,693.44 | $2,684,693.44 |

The statements submitted should disclose all information available.

Note that no dividends were paid on common stock.

From increase in land and buildings account, less write-up reflected in surplus and $100,000 purchase-money mortgage, ascertain cash payment for new land and buildings.

Note that increase in inventories—$15,072.50—was credited to cost-of-merchandise account.

*Solution:*

A point that is likely to be overlooked in the solution of this problem is that of dividends on the 7% preferred stock. The problem states "that no dividends were paid on common stock"; hence it must be inferred that dividends were paid on the preferred stock of $100,000 par at the rate of 7%, or $7,000.00.

STANDARD PRODUCTS COMPANY, INC.

Statement of cash receipts and disbursements for the year ended December 31, 1929

Receipts:

| | | |
|---|---|---|
| Customers' accounts (including cash sales) | $1,420,059.50 | |
| Income on investments | 5,000.00 | $1,425,059.50 |

STANDARD PRODUCTS COMPANY, INC.

Analysis of cash account for the year ended December 31, 1929

| | | | | Debit | Credit |
|---|---|---|---|---|---|
| Balance, January 1, 1929 | | | | $ 52,349.12 | |
| Collections on accounts receivable: | | | | | |
| Accounts receivable—January 1, 1929 | | | $ 155,036.45 | | |
| Sales | | $1,542,768.40 | | | |
| *Less:* returns and allowances | | 15,470.92 | | | |
| Net sales | | | 1,527,297.48 | | |
| Total | | | 1,682,333.93 | | |
| *Less:* accounts receivable—December 31, 1929 | | | 262,274.43 | 1,420,059.50 | |
| Interest on investments | | | | 5,000.00 | |
| Payments for merchandise: | | | | | |
| Accounts payable—January 1, 1929 | | | $ 82,030.78 | | |
| Net purchases: | | | | | |
| Inventory—December 31, 1929 | | $ 110,096.70 | | | |
| Cost of merchandise | | 1,134,964.90 | | | |
| Total | | $1,245,061.60 | | | |
| *Less*—returns and allowances | $ 8,742.50 | | | | |
| Inventory, January 1, 1929 | 95,024.20 | 103,766.70 | 1,141,294.90 | | |
| Total | | | $1,223,325.68 | | |
| *Less:* accounts payable—December 31, 1929 | | | 201,783.97 | | $1,021,541.71 |
| Payments for expenses: | | | | | |
| Vouchers payable—January 1, 1929 | | | $ 6,026.12 | | |
| Selling, general and administrative expenses | | $ 387,547.92 | | | |
| *Less:* depreciation | | 12,500.00 | 375,047.92 | | |
| Total | | | $ 381,074.04 | | |
| *Less:* vouchers payable—December 31, 1929 | | | 15,940.50 | | 365,133.54 |
| Dividends paid on preferred stock | | | | | 7,000.00 |
| Interest paid | | | | | 3,000.00 |
| Life insurance: | | | | | |
| Increase in cash surrender value: | | | | | |
| December 31, 1929 | | $ 7,675.70 | | | |
| January 1, 1929 | | 5,605.20 | $ 2,070.50 | | |
| Written off as life insurance expense | | | 6,279.50 | | 8,350.00 |
| Payment for land and buildings purchased: | | | | | |
| Increase in account: | | | | | |
| December 31, 1929 | $635,000.00 | | | | |
| January 1, 1929 | 285,000.00 | $ 350,000.00 | | | |
| *Less:* writeup as reflected in surplus account | | 200,000.00 | $ 150,000.00 | | |
| *Less:* purchase—money mortgage | | | 100,000.00 | | 50,000.00 |
| Balance December 31, 1929 | | | | | 22,383.37 |
| | | | | $1,477,408.62 | $1,477,408.62 |

| | | |
|---|---|---|
| Disbursements: | | |
| Accounts payable—merchandise | $1,021,541.71 | |
| Selling, general and administrative expenses | 365,133.54 | |
| Dividends paid on preferred stock | 7,000.00 | |
| Interest paid | 3,000.00 | |
| Life insurance | 8,350.00 | |
| On land and buildings | 50,000.00 | $ 1,455,025.25 |
| Excess of disbursements over receipts | | $ 29,965.75 |

STANDARD PRODUCTS COMPANY, INC.

Statement of profit and loss for the year ended December 31, 1929

| | | | |
|---|---|---|---|
| Gross sales | | $ 1,542,768.40 | |
| *Less*—returns and allowances | | 15,470.92 | |
| Net sales | | | $ 1,527,297.48 |
| Cost of sales: | | | |
| Inventory, January 1, 1929 | | $ 95,024.20 | |
| Purchases | $1,150,037.40 | | |
| *Less*—returns and allowances | 8,742.50 | 1,141,294.90 | |
| Total | | $ 1,236,319.10 | |
| Inventory, December 31, 1929 | | 110,096.70 | 1,126,222.40 |
| Gross profit on sales | | | $ 401,075.08 |
| Selling, general and administrative expenses | | | 387,547.92 |
| Profit from operations | | | $ 13,527.16 |
| Interest on investments | | | 5,000.00 |
| Total profit and income | | | $ 18,527.16 |
| Interest paid | | | 3,000.00 |
| Net profit for the year | | | $ 15,527.16 |
| Other charges: | | | |
| Life insurance | | $ 6,279.50 | |
| Federal income tax for the year | | 1,377.99 | 7,657.49 |
| Surplus net profits for the year (after providing for federal income taxes) | | | $ 7,869.67 |

On the assumption that the depreciation for the year as indicated by the invoice in the reserve-for-depreciation account was not based upon appraised

values, and that the corporation is the beneficiary of the life insurance policies, the income tax payable was computed as follows:

| | | |
|---|---|---|
| Net profit for the year | $ | 15,527.16 |
| *Less*—statutory credit | | 3,000.00 |
| Taxable income | $ | 12,527.16 |
| 11% thereof | $ | 1,377.99 |

STANDARD PRODUCTS COMPANY, INC.

Balance-sheet—December 31, 1929

*Assets*

| | | | |
|---|---|---|---|
| Current assets: | | | |
| Cash | | $ 22,383.37 | |
| Accounts receivable—trade | | 262,274.43 | |
| Inventories | | 110,096.70 | $ 394,754.50 |
| Investments | | | 100,000.00 |
| Life insurance policies (cash surrender value) | | | 7,675.70 |
| Land and buildings | | $ 635,000.00 | |
| *Less*—reserve for depreciation | | 87,500.00 | 547,500.00 |
| | | | $ 1,049,930.20 |

*Liabilities and net worth*

| | | | |
|---|---|---|---|
| Current liabilities: | | | |
| Vouchers payable (expenses) | | $ 15,940.50 | |
| Income tax payable | | 1,377.99 | |
| Accounts payable—trade | | 201,783.97 | $ 219,102.46 |
| Purchase—money mortgage (payable June 30, 1934) | | | 100,000.00 |
| Net worth: | | | |
| Capital stock: | | | |
| 7% preferred | $100,000.00 | | |
| Common | 200,000.00 | $300,000.00 | |
| Surplus: | | | |
| Balance, January 1, 1929 | $ 229,958.07 | | |
| Net profits for the year (after provisions for federal income taxes) | 7,869.67 | | |
| Total | $237,827.74 | | |
| *Less*—dividends paid on preferred stock | 7,000.00 | 230,827.74 | |
| Surplus arising from appraisal | | 200,000.00 | 730,827.74 |
| | | | $1,049,930.20 |

# Book Reviews

PRINCIPLES OF ENGINEERING ECONOMY, by EUGENE L. GRANT. *The Ronald Press*, New York.

*Principles of Engineering Economy* is primarily intended as a text-book for engineering students. It covers that part of the engineer's work which borders on the work of the accountant. Some chapters are indistinguishable from strictly accounting literature, as in the case where the book treats of methods of financing new construction.

Generally speaking, the author does not here deal with economies in the actual carrying out of engineering projects, but, assuming cost of construction and output capacity to be known, attempts to put the student in a position to be able to decide whether a contemplated piece of construction will be a profit maker or not and, if there be a choice of methods, a question as to size or as to quality of construction, to ascertain which method, which size, and which quality of work will pay best in all the circumstances.

In giving instruction in these matters the author has followed accounting methods that are in accordance with accepted practice and has given exercise questions that seem to be particularly well chosen. So far as an accountant can judge, this book should fill the place that it was meant to fill.

There is not much that would be of service to a competent public accountant, but the comments on depreciation methods, including provision for obsolescence, coming from an eminent engineering teacher, are not unimportant.

Comparing the sinking-fund method, depreciation at a fixed percentage of the diminishing balance and straight-line depreciation, Professor Grant shows a decided leaning toward the last named plan, partly because it is the simplest, but mainly because he considers that the sinking-fund method keeps the sum of two costs—interest on investment and depreciation—constant; fixed percentage on diminishing balance keeps the sum of maintenance and depreciation constant; and straight-line depreciation approaches a constant amount for the sum of interest, maintenance and depreciation. It should be remembered that the author is dealing with the economic aspects of new construction, and he expressly notes that the item of interest is considered apart from book entries to profit-and-loss.

The whole chapter on depreciation and obsolescence is excellent, covering conditions arising in rate fixing, sales of property and other circumstances. Incidentally the author distinguishes very properly between a reserve and a fund.

In the latter part of the book will be found a discussion of the advisability of new construction under specified conditions of supply and demand, intermittent operation, public utility laws and other special factors.

"Will it pay?" seems to be the text of the author; his book is well calculated to help the engineering student to a correct decision. The style is excellent.

F. W. THORNTON.

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SAVINGS BANKS AND SAVINGS DEPARTMENT MANAGEMENT, by WILLIAM G. SUTCLIFFE and LINDLEY A. BOND. *Harper and Brothers*, New York.

The book *Savings Banks and Savings Department Management* constitutes another contribution to the literature on business management of which there

has been a good deal published during the past year. It is noticeable that of late there has been a very definite trend toward management handbooks in various fields. Presumably, Messrs. Sutcliffe and Bond felt that the field of banking had been neglected and therefore decided to fill the gap. Their book is divided into three parts, which are entitled "History and competition," "Machinery and management" and "The problems of management."

In the first part, there are seven pages devoted to a dissertation on investment trusts, which undoubtedly will be of interest to students of this type of financial undertaking. But why the authors digress into the field of investment trusts, when their book is apparently intended to be devoted to savings banks and departments, is not clear.

Part II contains two chapters which are devoted to the organization of a savings bank and the duties of the officers. The authors state that, "since New York and Massachusetts laws are the models for most states, those statutes pertaining to the latter state will be used for illustrative purposes." Reference to the title page shows that both the authors are residents of Massachusetts so it is easy to understand why the laws of that state are so highly regarded.

The body of the book contains eighteen chapters which deal in an understandable fashion with the procedure followed in managing a savings bank or savings department. In chapter XXI, the reader will find a rather exhaustive treatise on the methods in vogue for calculating interest on savings accounts. This chapter contains a report of the committee on bank facilities and service, savings-bank division, American Bankers Association, that was originally presented in 1928. Undoubtedly, persons who are interested in the various plans in use for computing interest on savings accounts will be glad to avail themselves of the opportunity afforded for reading the committee's report.

In chapter XXIV, a lengthy discourse by Henry Bruère on service departments and their objectives will be found. Probably, persons who are admirers of Henry Bruère will be glad to read his treatise. However, I can not see how this paper fits in with the coherent presentation of the subject covered by Messrs. Sutcliffe and Bond.

The last two chapters of the book contain comments on recent trends, including a discussion of the cheque problem by Arthur A. Styvers and of a trust department for the mutual savings banks by John W. Kress.

The book is printed in clear type easily read.

De Witt C. Eggleston.

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CONTROL OF RETAIL STORE OPERATIONS, by Edwin A. Godley and Alexander Kaylin. *The Ronald Press Company*, New York. Cloth, 458 pp.

A practical manual for retail store controllers and managers is this book of Messrs. Godley and Kaylin, *Control of Retail Store Operations*, explaining the how and why of control through the accounting department. The constant appeal throughout the book for more coöperation by the heads of departments warrants the surmise that it is intended mainly for their instruction and enlightenment, and every controller may well hope it will attain its object. As one who has had some experience (though in another line of business) in trying to secure accurate data and prompt reports from heads of departments I can

speak feelingly. It is a book that will repay perusal by public accountants in general although its principles are to be found in any standard text-book. Naturally it goes into more details as to methods, forms, etc., and undoubtedly there are many points that would be applicable to other kinds of business. It can be safely recommended for use in training juniors in offices engaged in auditing retail stores.

W. H. LAWTON.

# Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

*Question:* Will you be good enough to answer a couple of academic questions as to the location of certain items on a balance-sheet, as follows:

1. *Surrender value of life-insurance policy*

Our client is doing a combination of wholesale merchandising and commission business and has taken out two policies on the two principals in the business. These policies are payable to the company. The company is paying the premiums. On these two policies the client has borrowed from the insurance company notes to within, say, 75% of the surrender value of the policies.

We have heretofore carried the surrender value of these policies, less the notes payable on them, as deferred assets; but we are now asked by our client to place the surrender value, presumably the net surrender equity, among current assets. We are of the opinion that this could be done by including the item among securities readily marketable, on the assumption that the cash surrender value is clearly the most liquid form of an investment. We are, however, in doubt about the advisability of including it among these current assets, for Montgomery's *Auditing* describes current assets as those which are bought for the purpose and with the intention of conversion immediately into cash. It would appear that our client's purpose and intention, judging from past performance, has been to borrow on the surrender value of his life-insurance policies fairly promptly after there was a margin in his favor; and hence his desire to place the item among the current assets is logical. In support of his views, he has seen the balance-sheet of a large eastern correspondent which shows the surrender value among the current assets. On the other hand, our own opinion is, in the absence of a positive practice, that the surrender value for a concern such as his, which is not expecting to go out of business but is doing business in a normal and usual manner, should be shown among investments.

*Answer:* It is our opinion that it is not proper to include this item under current assets. Our reasons for so doing are, in line with the quotation from Mr. Montgomery's *Auditing*, that the test of current assets involves three

things, purpose, intention and marketability. While the cash-surrender value of life-insurance policies may readily be converted into cash, as is evidenced in this case by the client's borrowing on the policies, at the same time it was not the purpose of the corporation in taking out the policies to create current assets but rather to make an investment and to protect the corporation from losses occasioned by the death of its valuable executives and it is not the intention of the corporation to change the original purpose. Accordingly, we believe that the item should be stated as an investment with the loan against the policy shown as a deduction therefrom. Incidentally, this procedure would result in a more favorable current ratio than if the cash-surrender value were shown as a current asset and the loans as a current liability. It would be absolutely improper, of course, to show the net cash-surrender value less loans as a current asset.

*Answer:* In dealing with the situation here outlined, among others we find as facts:

(a) That the company has set up on its books the cash-surrender value of insurance policies carried on the lives of its principals;

(b) That it considers such cash-surrender value as a current asset;

(c) That where there has been borrowed a part of such cash-surrender value and notes have been executed therefor, the liability on the notes is not included with other liabilities in the balance-sheet but is deducted from the surrender value and the net balance shown as an asset.

As we understand the question, two points are here raised: (a) is the method of accounting correct and, (b), if so, what is the correct place in the balance-sheet for the asset?

To arrive at a correct decision the particular circumstances require to be taken into consideration. A balance-sheet prepared on a "going concern" basis is, of course, not necessarily the same as one prepared on a "liquidation" basis. It is assumed that we are here dealing with a going concern.

Although it is quite common practice to set up—as in this instance—the cash-surrender value of such policies, something might be said in favor of carrying—as a permanent asset but not a current one—the total amount invested as premiums, the payments being looked upon as more in the nature of a funding transaction. Although not inferring that we would favor such a practice we mention it as presenting another viewpoint.

Insurance on the lives of principals in a business must necessarily be for the protection of the business. Surrender of such policies removes the protection. It is evident, therefore, that the premiums represent investment in protection and in no circumstances can they or any part of them be considered "an asset bought for or with the intention of conversion immediately into cash."

That portion of the premiums paid represented by surrender value, however, certainly has an immediately realizable value, but is it not clear that conversion of such value into cash correspondingly reduces the protection provided by the policies and can only be made at the sacrifice of such protection? Is it not more in the nature of an emergency asset, which could be realized—just as machinery or other more permanent assets could be realized—in case of need but is not purchased with that intent?

Within recent years an eminent scientist has popularized the word "relativity." Relativity of a specific item to all others in the balance-sheet and to the business itself are considerations having more or less important bearing on proper presentation of facts.

Current assets ordinarily consist of cash and such other assets as revolve or are being constantly converted into cash as a result of operations incidental to the business. That portion of the surrender value realized, i.e., the cash borrowed, already appears in current assets (although in the instance cited it should again be pointed out that the notes executed do not appear as liabilities). The balance, which by its very nature must be intended to be carried more or less permanently does not seem to possess the ordinarily understood attributes of a current asset except on a liquidation basis. It is an investment—or part of an investment—which to be justified at all must continue with the business, or at least as long as the conditions justifying it exist.

To our mind proper and accurate description of an asset is of importance at least equal to the position it may be assigned in the balance-sheet and we further believe that a "going concern" balance-sheet is strongest when, if classifications are made, doubtful items are conservatively classified according to underlying intent and their relation to the business as a whole.

2. *Current liabilities*

Current liabilities heretofore have included notes and accounts payable, but we have failed to include some items which we have been carrying as "other liabilities" on the balance-sheet. Our recommendation to the client now is to transfer from "other liabilities" to "current liabilities" items which are due and payable within a year, consisting of

(a) Commissions accrued, but not yet due.
(b) Deposits for maintenance of equipment sold.
(c) Local taxes accrued and not yet due.
(d) Reserve for income taxes.
(e) Reserve for legal expense.

The test of current assets as we understand it is that they shall be due within twelve months from the date of the balance-sheet.

We intend showing your reply to our client for the purpose of improving our service to him, as these changes are mildly opposed by the client, who hopes naturally to have us report his current assets as large and his current liabilities as small as possible, thus increasing the ratio of the difference between the two, which heretofore has been about $1.50 of assets to $1.00 of liabilities.

*Answer:* In practice current liabilities commonly include all ordinary trade or business liabilities other than those of an investment or capital nature, such for instance as long-term notes or other obligations, loans by stockholders, bonds, mortgages, etc.

Some balance-sheets make no distinction between current and other liabilities, but where such distinction is made current liabilities are ordinarily those incurred as a result of operations or transactions of the business which fall due within a cycle of time commensurate with the nature of the business. Usually, but not always, this cycle is considered as being one year.

In the specific cases cited it would appear that:

(a) Commissions, although not immediately due, certainly fall within the usually understood classifications of current liabilities unless—which seems unlikely—the liability has been set up in advance of any other action in connection with which such commissions accrue, is contingent on future profits and is not payable within a year. The use of the word accrued however in the instance cited would seem to preclude any such condition.

(b) Deposits for maintenance indicate a current liability, but its exact nature is not stated. It should be borne in mind that the cash thus deposited is in current assets on the other side of the balance-sheet, although this of course does not determine the currency or otherwise of the obligation.

(c) Local taxes come within the stated definition and are current liabilities.

(d) Reserve for income taxes similarly falls within this classification, as does

(e) Reserve for legal expense.

To provide in the balance-sheet a classification such as "current liabilities" and to include therein notes payable but exclude items of the nature indicated above seems not only unsound accounting but might give rise to the inference of some special purpose to be served.

As already stated, a proper and conservatively stated balance-sheet is at all times stronger than one which in any way appears to have been prepared to make certain showings even if technicalities seem to justify the presentation.

*Answer:* It is our opinion that the various items indicated should be treated in the following manner:

(a) Commissions accrued not yet due—current liabilities.

(b) Deposits for maintenance of equipment sold—deferred credits to income or other liabilities.

(c) Local taxes accrued and not yet due—current liability.

(d) Reserve for income taxes—current liability.

(e) Reserve for legal expense—treatment of this item should depend upon the nature of the reserve. If it represents really a provision for legal services already performed for which bills have not yet been received it would be shown as a current liability; if, however, it represents a reserve provided tc take care of possible legal expenses resulting from the corporation's operations, or disputes involved as a result of them, it should be treated as a reserve and be shown separately in the balance-sheet.

# Current Literature

Compiled in the Library of the American Institute of Accountants

[Photostatic reproductions (white printing on a black background) of most of the articles listed in THE JOURNAL OF ACCOUNTANCY or *Accountants' Index* may be obtained from the library of the American Institute of Accountants, 135 Cedar Street, New York, at a rate of 25 cents a page (8½ in. x 11 in.), at 35 cents a page (11½ in. x 14 in.), plus postage. Members and Associates of the American Institute of Accountants are entitled to a discount of 20 per cent. Identify the article by author, title, name of periodical in which it appeared, date of publication and paging. Payment must accompany all orders.]

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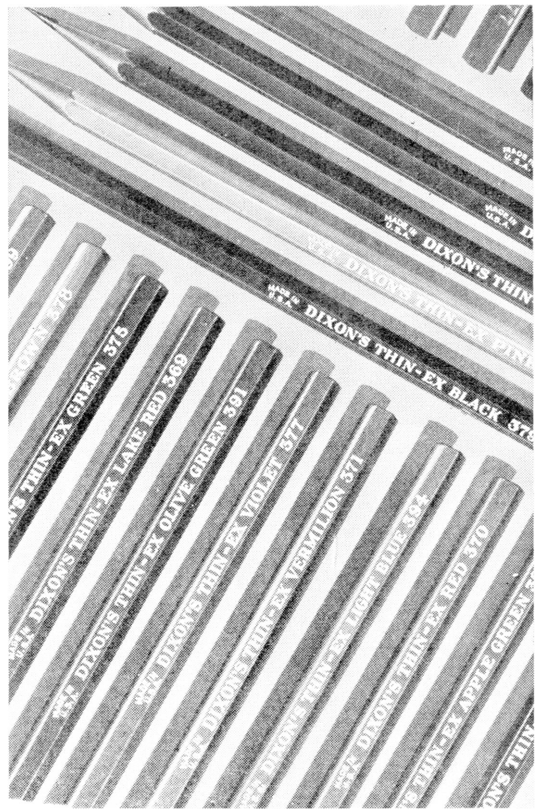


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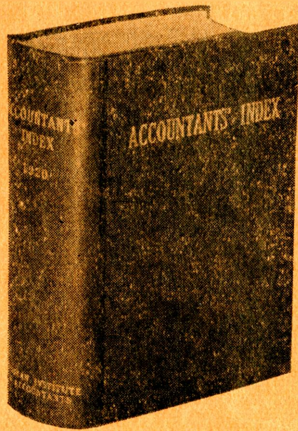

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