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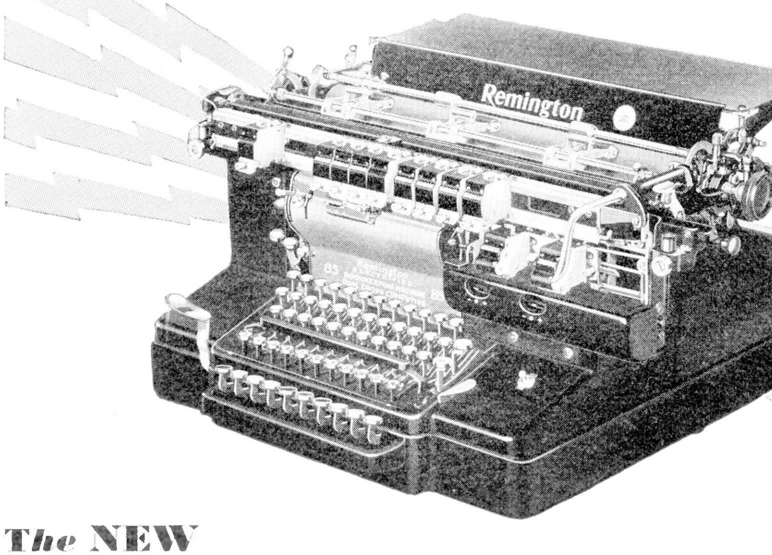

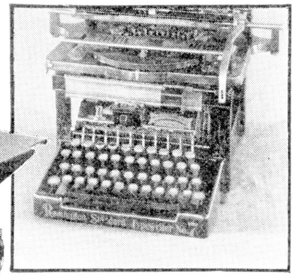

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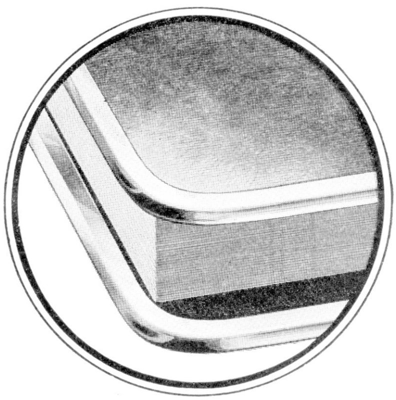

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The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

[*Opinions expressed in* THE JOURNAL OF ACCOUNTANCY *are not necessarily endorsed by the publishers or by the American Institute of Accountants. Articles are chosen for their general interest, but beliefs and conclusions are often merely those of individual authors.*]

VOL. 51 MAY, 1931 No. 5

EDITORIAL

Official Recognition of Accountancy's Value

Little by little the advantages of audit and investigation are recognized in those most conservative of spheres, the state and municipal governments. From the beginning of the republic it has been the custom to pay great attention to legislation and to let finance look out for itself, and as a consequence the waste in the administration of affairs throughout the country has been utterly criminal. Incompetent men, selected because of political influence, have juggled figures, stolen money and escaped punishment. Even where there was no intentional dishonesty there has been crass ignorance, and if anyone desired an ocular demonstration of the meaning of the word inefficiency he had merely to look into the offices of fiscal departments of any government, even the federal. Reform began in Washington some years ago and has been carried on quite rapidly. In some county and municipal affairs there has been a marked improvement, but as a whole the state governments have lagged behind. Because these things are true there is a peculiar satisfaction in reading the annual message of Governor John S. Fisher of Pennsylvania, which was presented in January to the general assembly of that commonwealth. Here is a splendid testimonial to the efficacy of competent professional accounting service. Let us quote:

"In the beginning of the administration, it was decided to make a comprehensive survey of the organization of the various departments, boards and commissions of the state government and their methods of handling financial and other governmental matters. It was thought this survey would disclose obsolete organizations, practices, and defects in the operation of the various agencies, and give a basis for an administrative programme of correction and elimination. To make this survey as rapidly as necessary to give the data upon which to act, the various departments, boards and commissions had audits of their affairs made by public accountants. These audits were made during the years 1927 and 1928 and a report of them was made to the general assembly in the governor's message accompanying the executive budget presented to the 1929 session of the general assembly.

"The total cost was about $550,000.

"The tangible results in dollars and cents were as follows:

"Cash recovered and deposited, including surpluses improperly held by departments, commissions and administrative boards having control of state institutions amounted to about $2,100,000.

"Obsolete and erroneous methods corrected, resulting in savings and increased state revenue estimated at $2,500,000 for each biennium of the administration.

"Indirect benefits accruing to the state government from these audits have proven to be of incalculable value. Practically all of the reconstruction and reorganization accomplished has been based upon the elimination and correction of conditions which they disclosed."

In other words, for an expenditure of $550,000 Pennsylvania recovered $2,100,000 and instituted reforms which produce an estimated saving of $2,500,000 every two years, and the indirect benefits are, as the governor says, incalculable. Some people have expressed the wish that accountancy might be advertised. Here is advertisement upon which a value can not be placed. What Pennsylvania accomplished with assistance of professional accountants every other state in the union, in proportion to the magnitude of its operations, may also accomplish. There is no state in which there is not need for such survey and recommendations as those to which Governor Fisher refers.

Restrictive Legislation

Among the letters received in the editorial office of this magazine relative to the question of restrictive legislation, as it is called, is one written by Guy V. W. Lyman of New Orleans, a member of the American Institute's committee on education. Mr. Lyman believes in the general principle of restrictive legislation, which means legislation that places restrictions around the practice of the profession in any state and requires those who enter the state from elsewhere to comply with certain rules for registration, etc. In some cases these laws absolutely prohibit an accountant, resident outside the state, from pursuing his vocation in the state unless it be to keep an engagement originating outside. Mr. Lyman's opinions are well considered, and while we do not believe that all restrictive legislation is desirable, we have pleasure in quoting the following extracts from his letter:

"I noted with a great deal of interest your editorial and also the letter of Arthur Berridge published in the March JOURNAL OF ACCOUNTANCY. It seems to me that Mr. Berridge has missed in his argument one of the most important reasons for restrictive legislation.

"At the time of the passage of the restrictive legislative act in Louisiana, that is during the year 1924, the arguments used in presenting the matter to the legislators and to the bank clearing houses and associations of commerce by the accountants of this state were that, by restrictive legislation, the clients of the accountants, that is the public, would receive a greater degree of protection because of the fact that through restrictive legislation all accountants doing business in the state would come under the jurisdiction and control of the state board of certified public accountants, and that by and through this means the public could be better protected against false statements and unprofessional conduct on the part of accountants within the control and jurisdiction of the state board. Certainly neither I nor, so far as I know, any of the accountants in this state had any thought of protecting the smaller accountants against the inroads of the large national organizations, but had in mind only the benefits that would accrue to the public and to the profession as a whole by forcing all practising accountants within the state to abide by the rules and regulations of the state board in order that unprofessional conduct on the part of any accountant might be promptly punished and the public thereby be protected."

It is quite true that there should be every possible protection accorded to the business men of Louisiana and every other state, and there can be no great force in an objection to compliance with a rule requiring registration. If that were all that is involved in restriction there would be not much room for discussion, but as a plain matter of fact restrictive legislation in far too many cases goes much beyond Mr. Lyman's conception of it. It is, no doubt, the policy of the authorities in Louisiana to be liberal and reasonable, but the trouble is that where there are restrictive laws there is always danger of their being made absurd and futile by endeavoring to inaugurate under their ægis a system of narrow restriction which can not be upheld if tested in the courts. Registration is one thing and perhaps quite a desirable thing, but there are forms of restriction which no one can logically support.

Public Interest the Controlling Factor

A further letter dealing with the question of restrictive legislation is published on another page of this issue of THE JOURNAL OF ACCOUNTANCY. The letter is written by Maurice E. Peloubet, who is chairman of the American Institute's committee on state legislation. The point which Mr. Peloubet urges with special emphasis is the desirability of a frank statement of the reason why some accountants favor restriction. He believes that restricting accounting practice to the accountants who are actually resident in any one state is not necessarily in the public interest, and, therefore, not to the advantage of the profession which it is supposed to assist. This, of course, is on the theory that what is opposed to the interest of the whole is opposed to the interest of the part. Mr. Peloubet also raises the question of the state of the small firm. We heartily agree with his opinion that there is room for both large firms and small and that in the process of time the class of work done by these two categories will be fairly divided. Where the small firm can do the work it will probably receive the engagement, but where a wide ramification of interest is involved the firm whose operations are spread over the country may be needed. It is not yet time to pull down the shutters in the house either of the small firm or the large.

Competitive Bidding Properly Damned

For a good many years it has been the constant effort of THE JOURNAL OF ACCOUNTANCY to discourage bidding for professional work. In recent issues of this magazine the subject has been discussed at great length. We have repeated an old argument, namely, that the best way to terminate calling for bids and bidding is for all accountants to refuse to bid. A correspondent draws attention to the *A. S. M. E. News* published by the American Society of Mechanical Engineers. The following excerpt from that publication is of great interest:

"The city of San Diego advertised for bids for the services of a sanitary engineer as reported in the December 22nd issue of the *News*. Advertising for bids for professional engineering services has been vigorously condemned by the American Engineering Council, the American Society of Civil Engineers and the American Institute of Consulting Engineers.

"As a result, when the day for opening the San Diego bids came, not a single competent recognized sanitary engineer had bid for the job. One bid was received from a resident, the bid it is understood containing the condition that the reclaimed water would be available for irrigation purposes.

"In the San Diego incident vigorous protests were filed by the American Society of Civil Engineers and the American Engineering Council and the results justify satisfaction on the part of the engineering profession.

"Fortunately it is not frequently the custom of municipalities to advertise for engineering services on a competitive basis, but if such occasions come to the attention of members they may render signal service by calling the attention of the society authorities to them."

This record reflects great credit upon all members of the engineering profession. It serves to show what can be done when the practitioners of a profession agree to work together. Presumably the authorities in San Diego must have known the feeling of engineers on the subject of bidding, and yet the advertisement was published. Probably San Diego will not call again for bids for engineering services, and an engineer will be engaged on a decent professional basis; but whether the municipality decides to do without an engineer or not the good name of the profession is maintained and sooner or later the absolute necessity for engineering assistance will bring the city to its senses.

Depression and Accountancy

The line of unemployed accountants, men who have been unable to find employment or have been discharged from other accountants' offices, is longer this year than it has been for a decade. Possibly it is longer than it has ever been before, because there are more accountants now, and consequently when the demand for accounting services declines there is a greater number of unemployed men. Every accountant is familiar with the problem which arises at the end of March each year, when the rush of the winter is over, income-tax returns have been filed and all that remains to be done is the routine work which can be spread over the year. All efforts to encourage corporations and other business entities to close their books at dates other than December 31st have failed to achieve complete success. Here and there a concern has consented to adopt a fiscal year not coincident with the calendar year, but most organizations having been forced in the early days of income taxation to adopt the calendar year have been reluctant to change again. They have failed to grasp the great importance to themselves of closing their books at the time when inventories are lowest. Too often they seem to feel that the urge of the accountant for the adoption of the natural fiscal year is dictated solely by the accountant's own interests. They do not understand that the natural year is a far better index of progress or condition than an artificially created closing governed by nothing more imperative then an arbitrary calendar. The income-tax department in Washington and similar departments in states which have to administer income or excise taxes are much assisted by spreading the closing of corporation books over the whole year. Accountants, of course, are vitally concerned, but the fact that they are parties at interest should not prevent business men from seeing that in this case at least the convenience of both client and accountant is best served by following the natural course of business and terminating the fiscal year after the busy season is over. Every business has its peaks and depressions in each year and every business has a time when the books can be closed with the least difficulty and the best results. However, all these arguments have been brought forward many times and business men still refuse to be convinced. As a consequence the rush of the winter has become an annual event foreseen and dreaded.

False Economy

This year the height of the season was earlier than usual and the laying off, as it is called, of men began before the end of February. By the end of March the staff of nearly every accounting office had been reduced substantially and the queue of applicants for positions grew steadily. This was not due entirely to the seasonal nature of accounting practice. It was attributable in great part to the general fear which has caused the depression. Everyone now admits that the worst is past and that with the resumption of confidence there will come a renewed desire and ability to purchase. Accountancy, however, always lags behind the swings of the pendulum. The depression was not felt in accounting offices as quickly as it was felt in many places, and the return of prosperity will not be felt immediately. This is true because a great many business men seem to feel that accounting is a luxury. When business is thriving and profits apparently mounting, many men are inclined to engage accountants to review the conditions, make recommendations for betterments and do a host of other things which accountants can do, but most of all the accountant is called in to compute profits. That is what the business man wants to know first of all. If there are leakages or wastes, if means might be devised to increase profits and cut losses the recommendation of the accountant will be carefully considered, but first the business man says: "How much have I made?" Consequently when he is fairly sure that he has made nothing he begins to think that the services of the accountant are superfluous and he resolves to save the accountant's fee during the lean years. This seems to us unwisdom. It is very much like the principle which some industrialists favor of ignoring depreciation during hard times. The depreciation continues and may indeed be accelerated by disuse of machinery, but because there are no profits against which depreciation can be charged these men like to deceive themselves and try to imagine that there is no depreciation because there is nothing to compensate. So the corporation or other organization which attempts to save by the omission of accounting services overlooks the truth that if accountancy is necessary in good times it is far more important when every penny must be watched and every safeguard maintained. One might go further and say that if there were to be years in which accounting services were omitted the wise business man would select the years of prosperity when profits are accumulating and losses will not be so evident nor will they be so serious. In times like the year 1930 there are very few businesses which can afford to neglect the orderly conduct of records and the review of them. Yet that is what scores of business men have done and that is the real reason why the long line of applicants for positions is so distressing at present.

What Can Be Done about It?

What are these men to do? Most of them are fairly good accountants and some of them are men of outstanding ability. Those who have no title to consideration because of inefficiency or inexperience may be pitied, but they need not be the subject of much special attention. They would probably do as well in any other occupation as in accountancy. What every friend of accountancy deplores at present is the lack of employment for the really good men. The large accounting firms which employ the greatest number of men can not be expected to keep staffs at full strength during idle times. Many of the firms are carrying on their payroll men who are not of much present value but have served well in the past and will be needed in the future, but even the firms which have the ability to continue their organization at something approaching normal size can not take care of all the men who are available. Every profession and trade has a somewhat similar problem before it at the present time and the answer is unknown. It is a lamentable fact that most men are improvident, and this is perhaps more general among the salaried classes than among the wage earners. The man who is receiving a salary of $3,000 or $4,000 a year could perhaps live on $2,500, but he does not, and at the end of a period of prosperity when he has had three or four years of steady employment he probably has nothing in the bank to carry him over the time of unemployment. Accountants are not worse than other men and their present distress is not exceptional nor restricted to them. The whole cause of the present unhealthy condition is in the instability of business relations and international affairs. It is conceivable that there might be a time when supply would be kept within the bounds of demand and when periods of great prosperity would no longer recur, but all would be even, calm, serene. Pending the coming of that ideal day there will be fluctuations in all business and one must expect after the feast a time of famine. That philosophy does not relieve the pangs of hunger, but it is true nevertheless. Every accountant regrets that so many of his fellows are in need at present and many a man is doing the best and most he can to relieve others. There is a vast amount of kindliness which is never advertised. The only consoling thought which can be proposed now is that with the clear evidence of a better trend comes a hope that accountancy in accordance with precedent will ere long resume its onward march.

Accountancy's Part in Progress

The well-known publicist, H. Stanley Jevons, contributes an important article to the *Economic Journal* (London) for March, 1931. The subject is "the second industrial revolution" and the thesis is that the advanced industrial countries of the world are now in the first stage of a sweeping change of the methods and organization of all their secondary industries. Professor Jevons thinks that this new movement may be comparable in its effects with the changes brought about in what is commonly called the "industrial revolution" beginning in the latter part of the eighteenth century. The author says that the essence of the new industrial revolution is the search for exact knowledge and the planning of processes: from the minutiæ of manual operations (based on motion study) to the lay-out of the machinery of a gigantic plant—even of a whole industry throughout the country. At the beginning of the article Professor Jevons advances a theory which is of great interest to accountants. He says:

"The movement appears to have had its origin in the union of three distinct trains of ideas, which evolved with their corresponding actions. Accountancy ceased to be a mere record of past events and developed in the latter half of last century into an applied science designed to aid the business man in the policy of his operations (e. g. by determining the relative profitableness of different sections of a business, rates of amortisation, etc.) coincidently with the rise of the profession of chartered accountants. This led to the invention of cost accounts for factories so far back as the 'eighties."

The other trains of ideas to which the author refers originated with engineers, who applied pure science to construction, and among manufacturers and business men generally on account of ever-increasing competition.

Importance Should Be Understood

The whole article is one that may be read with interest and profit. Suffice it here to say that it is gratifying to find so eminent an authority as Professor Jevons placing accountancy at the head of the list of causes for the great changes which are taking place in industry and commerce. Too often accountants themselves are apt to overlook the tremendous significance of their work and to regard it solely as an expression of individual energy without much thought of the results to the body politic. It is the merest truism to say that in the present condition of the world and its people what one person does affects the multitude. We all know that our actions are part of a titanic piece of machinery, but some of us forget that there are some cogs and bearings which are more important than others. When a careful student of political economy places accountancy at the top there must be good reason for such a choice. Quite often it is true that the man outside the actual arena is in a better position to watch the tournament than those who participate, so Professor Jevons, sitting on the side lines, sees accountancy performing a rôle of outstanding value. It is, to say the least of it, inspiring for an accountant to be able to feel that he is not only a part but a vital part in the machinery which turns the wheels of progress.

Banks as Auditing Companies

A correspondent has asked us to say something about the activities of certain banks and trust companies which have undertaken to perform services that are supposed to be the function of public accountants. For a good many years there have been a few such institutions in various parts of the country which have conducted what they call auditing departments. The procedure is comparatively simple: A borrower coming to the bank for money is asked if he has an audited statement of affairs to present in support of his application for credit. If he says that he has such a statement it may satisfy the lending officers of the bank, but there have been cases in which the officers have said that they could not accept the certificate of the auditors selected by the borrower and must have an audit made by their own audit department. Of course, if the borrower has no audited statement it is even easier for the officers of the bank to suggest the engagement of their own audit department. In either case the practice is bad. To begin with, banks should not be like the corner drugstore, an emporium where everything is offered for sale. There would be a great outcry from the legal profession if banks were to attempt to give legal advice. In fact there is a good deal of heartburning because some banking institutions undertake to write wills for customers. Lawyers feel that this is an encroachment upon their preserves. There would be much opposition if banks maintained engineering departments whose services could be engaged by customers. There is no more justification for an auditing department engaging in public practice than there is for a legal or engineering department in a bank to enter the fields of those professions. The bank does not offer to render the service gratis, but the theory is that the auditing department must pay its way.

Accountancy and Banking Not Marriageable

It seems to us utterly wrong that a banker should be in a position to insist that his own institution be engaged to perform the audit before another branch of the same institution will extend credit. The two things do not march together. It must be remembered that if a branch of a bank performs an audit of a customer's accounts that department, being the servant of the bank, will naturally attempt to regard everything from the bank's point of view, and it will be difficult indeed to maintain an absolutely impartial attitude while conducting the audit. Furthermore, it looks quite like what today is called a "racket" for a bank to hold up its customers and insist that they, the banks, shall have the right to perform a professional service through a purely commercial department. We are becoming so accustomed to read of rackets, graft and extortion of one kind or another that such comparatively minor offenses as banking adventures into accountancy may be easily overlooked, but accountants are vitally concerned and they can not afford to ignore any attempt to interfere unfairly with the conduct of accounting practice. Unfortunately accountants are not as numerous or of such established standing as the lawyers. The latter are well organized to protect their own interests and it is practically courting defeat to attempt any encroachment upon the legal field. Accountants, however, can do a great deal to educate the public, particularly the bankers, as to the fallacy of the auditing-department notion. Bankers may attempt to justify the existence of auditing departments by asserting that they can not depend upon accountants' reports and must have their own employees do the work before they can be satisfied. That argument is no better than it would be if applied to legal services. The simple truth is that a banker should stick to his banking and an accountant to his accountancy. It is better to avoid any intermingling of the two vocations, so that the interests of banker, accountant and the general public may be well and independently protected. There is not, apparently, quite so much evidence of a desire to enter accountancy by bankers as there was a few years ago, but there is still enough of that spirit of expansion to merit attention. Wherever the movement is started it should meet with opposition before it can gather momentum.

Motion-Picture Production Accounts

By H. S. Brewster

Producers of motion pictures may be divided into two general classes: those owning and operating studios and those renting studio facilities. Unless otherwise stated the following comments refer only to producers who operate their own studios.

Studio Organization

In order to appreciate the intricate departmentalization of a studio, the studio organization of one of the larger producers is shown below:

- Vice-president in charge of production (all studios)
  - General manager of production (all studios)
    - Managing director of production
      - Assistant to managing director
        - Associate producers (supervisors)
        - Scenario department
          - Writers
          - Reading department
          - Stenographers
      - Executive manager
        - Comptroller
          - Accounting and auditing department
          - Timekeeping department
          - Medical department
          - Insurance department
        - Legal department
        - Casting office
        - Music department
        - Sound department
          - Projection department
      - Laboratory
      - Publicity department
        - Fan mail department
        - Still department
          - Retouching department
      - Production manager
        - Directors and assistants
        - Actors
        - Art department
          - Glass shot department
        - Business managers
        - Estimating department

Cutting department
Camera department
Studio manager
  Construction department
    Carpenters
    Plasterers
    Plaster shop
    Prop-making department
    Scenic department (painters)
    Laborers
    Nurserymen and gardeners
  Mechanical department
    Blacksmith shop
    Foundry
    Machine shop
    Sheet-metal workshop
  Engineering department
  Electrical construction department (maintenance)
  Electrical operating department (set electricians)
  Set-dressing department
    Prop department
    Drapery department
  Special effects department
    Miniature set department
    Trick-shot department
  Location department
  Transportation department
  Research department (library)
  Prop-handling department
  Grip department
  Character-wardrobe department
    Wig and make-up department
  Modern wardrobe department
  Title department
  Printing shop
  Purchasing department
  Refrigeration department
  Information and mail department
  Firemen
  Watchmen and special police
  Janitors
  Telephone and telegraph operators
  Restaurant

Production Procedure

Before considering the cost accounts of a studio it may be well to set forth in chronological order the various steps followed in the actual production of a talking picture. There are, of course, certain minor variations in the production methods employed by the different producers, but in general the procedure is as follows:

The sources of material for a picture are original ideas and original stories developed in the scenario department or purchased outside, novels, short stories, and stage plays including operas, operettas, musical comedies and dramas. The reading department prepares synopses of all stories considered suitable for filming, which are then reviewed by the scenario department and studio executives at story conferences. After a story is selected silent and sound motion picture rights are acquired.

If a story is purchased it is submitted to a writer who adapts it to the screen by condensing or otherwise revising such action and dialogue as is necessary. This adaptation is known as a "treatment" and is usually reviewed at story conferences before being approved by the studio executives.

From the "treatment" is prepared a "continuity" commonly referred to as a "scenario." A continuity is a chronological arrangement of the action and dialogue into sequences, sets and scenes. A supervisor and a director are assigned to the picture and coöperate with the scenario and dialogue writers in the preparation and arrangement of the final continuity. Mimeograph copies are made from the continuity, each copy being referred to as a "script."

The supervisor, director and casting director coöperate with the production executives in the selection of the cast. An assistant director, cameramen and other members of the production unit are also assigned.

The assistant director prepares a "break-down" or "script analysis" of the continuity. A break-down sheet is prepared for each set showing the following information:

Production title
Page number
Name and number of set
Total number of scenes
Scene number and short résumé of action of each scene
Essential description for construction of set
Essential props for dressing set
Cast and wardrobe change
Extra talent and bits
Special effects required
Music and miscellaneous requirements

The production department reviews the script, break-down sheets and cast selection and prepares a "cross chart," which lists the individual members of the cast down the left-hand side of the schedule with a column designating each set across the top. A cross is placed opposite each name in various columns to indicate the particular sets in which each member of the cast will appear. The purpose of the cross chart is to effect an economy in the engagement of outside actors not under contract, to provide a basis for arranging a "shooting schedule," and to determine when the outside talent should be placed under contract.

For example, the cross chart is first prepared with the sets in chronological order—however, a high salaried actor (who will be engaged on the basis of a weekly salary) may appear in the first few sets and one or two of the last with no appearances in between. The set columns are then cut into strips and rearranged so that all the scenes in which the outside actor appears will be grouped together in a consecutive order and thus shorten the period of time that the actor need be placed under contract. This procedure is followed for all outside talent as closely as possible until, in conjunction with other important factors, a satisfactory schedule is arranged for the photographing or "shooting" of each set. No particular consideration is given to the appearances throughout the production of stock actors under term contracts or of any actor who is guaranteed a specific amount for the picture.

The length of time required for shooting each set is estimated and a tentative shooting schedule is prepared from the cross chart.

After a study of the script, break-down sheets and shooting schedule, the heads of the various operating departments furnish the estimating department with individual estimates of the cost of sets, set dressing, wardrobe, extra talent, miniature sets and trick shots, location and electrical expenses, etc., which in turn are used in estimating total cost of the picture. A "budget" meeting is attended by the production executives and department heads, and the estimated cost is compared with the budget authorized by the home office. If the estimate appears too high the studio executives may decide to shorten the script or effect certain economies in the construction of sets, etc.

Interiors and exteriors built especially for a production are known as "sets." The art director designs the sets and plans are prepared by architects and draftsmen which, when approved by the supervisor and director, are submitted to the technical or construction department. The sets are constructed in the order designated by the shooting schedule. Light platforms are built over each set to hold the electrical equipment. The amount of available stage space will determine the extent to which sets may be constructed in advance of the actual shooting of the picture.

The scientific research department constructs the miniature sets and produces the trick and process shots to be used in photographing the picture. General and special effects are developed by the use of explosives, fireworks, flares, smoke pots and wind machines.

Ceilings ordinarily are not built on interior sets but glass shots are used where the effect of a ceiling is required as in the case of a large ball room or café scene. Economies are frequently effected in the construction of exterior sets by painting roofs, etc., on glass placed in front of the camera.

The wardrobe designer designs the special costumes that are to be made in the studio and authorizes the purchase or rental of any other costumes, uniforms, etc., required by the cast for all changes of wardrobe. In the case of a picture depicting scenes in foreign countries or certain periods in history, the wardrobe designer may confer with the research department as to the modes and styles of dress. In the case of an ultra-modern picture it is necessary to anticipate the styles as far in advance as possible, as several months may elapse after the completion of a picture before it is released and the costumes must not appear out-of-date.

If theme songs are to be featured in the production, the musical composition and lyrics are composed and written by the music department or, if a musical comedy or operetta is reproduced, the music rights to all copyrighted songs must be purchased. The dance director rehearses all chorus numbers.

Usually the day before rehearsals start the set dresser will supervise the arrangement of the props on the set and the hanging of the "drapes." The following are considered props:

Rugs, carpets, etc.
Furniture, pictures, statuary, etc.
Electrical fixtures
Shrubs, plants, trees, lawns, etc.

The prop department furnishes such articles as are in stock suitable for dressing the various sets and the remaining props are purchased or rented. Most of the larger studios maintain a department to build special furniture, statuary, etc., required.

The head electrician is responsible for the lighting of the sets. Rifle, spot and overhead lights are aligned in a row around the top of the set on the light platforms or are suspended overhead, while the larger incandescent lamps are placed on portable light platforms or are otherwise moved into position.

The chief sound technician or the "head mixer," who is responsible for the blending of all sound, supervises the placing of the microphones and the leads which connect them with the portable mixer's booth and the channels leading to the recording equipment. The most up-to-date sound studios have a "cross patch" panel board permitting the connecting of any one of the various sound stages with any one or more of a number of recording rooms.

Certain phases of the continuity may call for sequences to be taken "on location." All sites selected for scenes other than on sets built at the studio are considered locations. The location department selects the sites subject to the approval of the supervisor or director and secures licences or permits if public property is to be used, and agrees upon rentals with owners of private property. The transportation department furnishes trucks and automobiles to haul materials needed for dressing the location set, cameras, portable sound equipment, etc., as well as the staff and cast. Arrangements are made for hotel accommodations and meals where the location is too distant to permit the company to return to the studio at the end of each day.

All preliminary work having been completed just prior to the opening date on the shooting schedule, the assistant director prepares and issues call sheets indicating the members of the cast who are to report and designating the description and location of the set upon which photography will commence, i. e., "interior of nightclub"—"stage No. 6." In addition to the cast the following members of the operating unit or staff report for duty:

- Supervisor
  - Director
    - Assistant director
      - Second assistant director
      - Script clerk
    - Head or first camerman
      - Second camerman
      - Assistant camermen
    - Head electrician
      - Electricians
    - Set dresser

Head prop man
  Prop men
  Nursery men
Stand-by painter
Stand-by carpenter
Headgrip
  Grips
Wardrobe matron
  Hairdresser
  Make-up men
Head mixer
  Mixer
  Microphone men
  Sound-maintenance man
  Recorder

The action and dialogue are rehearsed by the actors under the supervision of the director. If the set is a large one it is customary to use four or five cameras placed at varying angles. The lighting is tested and the head cameraman decides whether or not the lights are properly balanced over the spot on the set where the action takes place; if not, certain lamps are dimmed through the use of diffusers or others are intensified from certain angles by the adjustment of reflectors. In the meantime the head mixer tests the voices of the actors on the set and perhaps orders a change in the location of some of the microphones and adjusts the volume of each from the mixer's booth so that all voices on the set blend together without the predominance of any one.

With these preparations complete, the director calls "Lights—A. C.—turn them over" and the electricians flood the set with lights, the head mixer presses a button, flashing a green light as a signal to the recorders to turn on the alternating current, which "lines up" and locks the camera motors with the motors for the recording equipment. After an interval of a few seconds the recorder turns on the "D. C." or direct current which flashes a red light on the set and this is a cue to the characters in the scene to proceed with the action and lines. The director may interrupt at any point for corrections in manner of action or tone and inflection in speech, by saying "Cut" or "N. G." and all action stops.

As the shooting progresses the script clerk prepares a report of the shots taken, indicating those which are considered "good takes" by the director. The assistant cameramen prepare reports for each camera indicating the number and footage of each shot taken for each scene. All "good takes" are circled as a guide for the laboratory and are marked either for developing and printing or for developing and holding in reserve. Camera, take and scene numbers are punched in the film two or three feet after the end of the exposed negative on each shot. These numbers are used later to identify each section of film in the laboratory, so that "N. G." takes need not be developed. Some producers still use camera slates, showing name of director and production, scene and set number, which are photographed immediately following each sequence of action to identify it after the negative has been developed. This is the common practice where the work is to be done by independent laboratories.

The still cameraman takes one or two photographs of each scene. These are developed and used by the publicity department in the preparation of lobby displays, billboard advertisements, etc.

Concurrently with the photographing of the action, sound is recorded on waxes or sound track film, or both. Each recording room is in charge of a recorder and is usually equipped with at least two recording instruments. Where the sound is recorded on wax at least two are used for each shot in order that one wax may be used for an immediate reproduction, called a play-back, should the director deem it necessary. An advantage of this method is that if the recording of a scene is questioned, supervisor, director and principals can retire to a "play-back" room on the stage immediately after the scene is taken and listen to a reproduction of the sound as played from one of the untreated waxes, which enables the director to decide at once whether or not the scene should be retaken. The play-back is accomplished by having the recorder substitute a reproducing device for the recording mechanism.

The recording room is also equipped with a loud speaker which can be amplified as the sound is recorded. This enables the recorder to detect any high or harsh notes which may "break-down" the wax, and by looking in a microscope, stationed directly over the wax, the width of the sound track can be measured by a graduated scale. When the sides of the sound track are too jagged and abrupt, the needle can not follow the depressions after the record has been made.

As more than one take is usually recorded on a wax, the recorder prepares a recording report indicating the wax, production, scene and take numbers, which are also scratched on the wax.

The takes considered good by the director are so marked on the report for the identification of the sound department.

When the film in a magazine is entirely exposed (except for short ends) the camera is reloaded. All exposed magazines are delivered to the studio laboratory at the end of each day. The magazines together with the cameramen's daily reports are taken into the negative dark-room and the good takes are developed. Prints are then made of the takes marked for printing on the cameramen's reports.

Where sound is recorded on film the processing of the sound track is the same as in the developing and printing of the negative and positive film. The waxes on which sound has been recorded are delivered each day to a record plant of an independent manufacturer and the same process is followed as in the making of phonograph records. Briefly, the procedure is as follows:

The wax is painted with copper bronze dust and submerged in a solution of copper sulphate between copper anodes. By process of electrolysis a copper coating is formed on the wax. When of a proper thickness the coating is separated from the wax and is placed upon a copper plate which acts as a backing. This first coating is conversely convex to the depressions in the wax and is known as a master record. By reversing the process a concave mother or matrix record is prepared from the master record. The process is extended by developing a convex stamper from the concave matrix. The stamper after being backed and processed is placed in a hydraulic press and is used in stamping out records from a compound which has shellac as a base.

At the end of each day the studio executives, supervisor and director watch "the daily rushes," which are the projection of the prints made from the negative exposed the preceding day, simultaneously with the playing of the records stamped out. If the rushes are considered satisfactory, orders may be given "to strike" or tear down the sets on which all scenes have been completed. However, if unsatisfactory the director is instructed to retake the scenes where improvement in action, photography, etc., is deemed necessary.

The cutting and editing of the approved positive prints are completed before the negative film is cut. The cutter assembles the good takes into scenes and sequences by selecting the best camera shots. For example a medium shot of a particular take may be more suitable than a close-up or long shot. After the shooting of the picture is complete, the cutter arranges the assembled sequences in a chronological order and this positive film is then referred to as the "first-cut" print.

When the cutter has selected the best camera shots making up a scene, the corresponding dialogue, music or sound effects must be placed on the sound track film or records. The sound track film is cut to synchronize with the positive print. In the case of recording on wax, the cutter prepares a report for the sound department indicating the beginning and end of each section of dialogue, etc., to be used in synchronizing with the first-cut print. This report is essential, as an individual record frequently has had three or four takes of the same scene, whereas only portions of certain good takes may have been used. Further, several records may have been used in recording the sound for a particular sequence.

The sections of dialogue, etc., selected by the cutter from the numerous records must be combined and recorded on a new wax to correspond with each reel of the first-cut print. This re-recording from the various records to a single wax is called "dubbing" and is accomplished by the use of a special machine. Records are prepared from the new waxes for further use in editing.

The first-cut print is then edited by the supervisor or studio executives and the original length of approximately 10,000 to 15,000 feet is reduced to a length suitable for release, by entirely eliminating or shortening the action of certain sequences. The release length of a programme picture naturally varies from that of a special feature production. Before the final editing is complete the picture may be previewed in certain local theatres for the purpose of obtaining the reaction of the audience to specific sequences. This enables the studio officers to retain in the final "cutting print," those portions of the picture which are most favorably received.

The negative is then cut to match the cutting print, and studio or sample, copyright and censorship prints are made. Final synchronized records or sound track prints are also made. This completes the work done by the production department in preparation of the domestic negative, although release prints may be made by the studio laboratory. The cost of the release prints is charged to the distribution department.

A foreign negative is then cut and synchronized with dialogue in English. Versions are now frequently made in foreign languages such as French, German and Spanish. The procedure followed is similar to that used in making the domestic negative.

Production Accounts

The extent of the departmentalization of a studio determines to a large degree the classification of production accounts. All studios recognize the necessity of maintaining separate cost accounts for each production and, to facilitate this, a specific number is assigned to each picture. In general, the expenditures of the various studio departments which can be distributed directly are charged to specific productions and the indirect expenditures to studio overhead accounts. The charges accumulating in the overhead accounts are later apportioned to all productions on bases varying at the different studios. The methods used in making this apportionment will be referred to later.

The classification of picture costs maintained by producers is not uniform, the number of sub-accounts varying between studios from twenty to seventy-five. However, these sub-accounts may be classified under certain main headings as follows:

- Direct charges:
  - Scenario
  - Staff
  - Cast
  - Sets:
    - Construction
    - Dressing
    - Lighting
    - Location
    - Effects
  - Wardrobe
  - Action and hand props
  - Negative film and sample print
  - Sound recording
  - Music and sound effects
  - Other charges
    - Total direct cost
- Indirect charges:
  - General studio overhead
    - Total studio cost

Direct charges include certain expenditures incurred only for a specific picture. In addition to these specific charges there are salaries of writers, supervisors, directors, stars and stock talent engaged under long-term contracts, which must be apportioned between several pictures. The various studios use different methods in allocating these salaries to productions. For example, each production in which the star appears may be charged:

(1) With a proportionate amount of the yearly salary based upon the estimated number of pictures in which the star is to appear;

or (2) With the weekly salary paid to the star during production together with the accumulated salary paid during waiting time;

or (3) With the weekly salary paid to the star during production, plus a surcharge on a percentage basis estimated to offset idle or retaining time;

or (4) With the weekly salary during production. (All salaries paid during idle or retaining time being charged to general overhead).

The first method outlined is the most equitable if there are no changes in the studio production schedule and the star actually appears in the number of pictures originally estimated. It frequently happens that a less number of productions than originally estimated is completed which necessitates a revision of the charges to the completed pictures or a redistribution of the charges to the productions not then released.

The second method is equitable when approximately the same length of time elapses between the star's pictures. Where a star remains idle for a considerable length of time and then appears in two productions with practically no interval of time between, the second picture should be charged with a fair proportion of the idle time which accumulated prior to the commencement of the first picture, so that each production will be charged with approximately an equal amount of retaining time or "suspense salaries."

The main advantage of both the first and second methods lies in the fact that all idle or retaining time of stars is allocated directly to the productions affected and is not absorbed in general overhead and distributed over pictures in which the particular star does not appear. In cases where a contract is terminated unexpectedly, the undistributed retaining time is usually transferred to general overhead. If the amount is large it would appear more equitable to adjust the cost of the unreleased pictures in which the star appears.

In actual practice numerous changes are made in the production schedule of a studio. For this reason the use of the third method is impracticable, as too many revisions are required in finding an average surcharge rate which will satisfactorily offset all idle time.

The fourth method, although used by one of the larger producers, is the least equitable and is not recommended.

In verifying direct production costs, it should be determined that the treatment of all retaining time is consistent and that the method used is equitable. This question is of particular importance where the examination is restricted to the verification of the cost of a specific picture produced under the terms of a profit-sharing contract.

With reference to the charges included under the main headings of production cost the following comments will be of interest.

Scenario:

The scenario account is ordinarily charged with the cost of original stories acquired or the amounts paid for silent and sound motion picture rights to novels, short stories, stage plays, etc., and with the salaries of continuity and dialogue writers, production editors, technical advisors, translators, research workers, "gag men," stenographers, etc., actually engaged in the adaptation of the treatment and the preparation of the continuity or script. The salaries of readers are usually charged to scenario-department expense under general overhead unless they are assigned to research or other work on a specific production.

The verification of the charges to the scenario account should comprise an examination of vouchers, contracts and assignments covering the purchase of original stories or rights together with the clearances issued by the government copyright office. Contracts should be examined in support of all payments to writers and the distribution should be tested by reference to time sheets and the daily bulletins or assignment reports of the scenario department.

Staff:

Staff salaries are paid to the following:

Supervisors
Directors and assistants
Script clerks
Unit business managers
Cameramen and assistants
Company prop men, set dressers and grips
Stand-by painters and carpenters
Make-up men, hairdressers, and wig makers

Special personnel:
- Technical advisors
- Dancing directors
- Fencing masters
- Company wardrobe matron

In addition to contracts, payrolls and cancelled cheques, the assistant directors' daily reports furnish information as to the principal members of cast and staff actually engaged on each production. "Start and stop" employment cards are prepared for all employees which are approved by studio officers and these should be referred to for weekly salary rates where formal contracts have not been signed or to determine date of termination of employment. Reference should also be made to any other statistical reports prepared by the studio departments.

Cast:

The cast is usually subdivided as follows:

- Star
- Stock talent
- Outside talent
- Extra talent
- Musicians (when engaged to appear in scenes)

Actors, other than stars, under term contracts are referred to as stock talent as distinct from outside talent, engaged for only one picture. Extra talent and "bit" actors are sometimes engaged directly by the casting director, but the majority of the extra people are engaged through casting agencies.

In verifying the item of star's salary it should be ascertained through examination of the contract whether the artist is engaged for one or more pictures or for a period of time such as one year with options to extend.

If the artist is engaged for one or more pictures, the contract may provide a flat sum per picture as compensation, or a weekly salary during the shooting period with a minimum period specified of, say, from three to six weeks. Under the terms of certain contracts the star will receive, in addition to a flat sum, which should be charged to the cost of production on the studio's books, a royalty based upon a percentage of the producer's share of film rentals or profits from the release of the production. The latter item is not of course a picture cost and is one which is handled by the head office in the general accounts.

When the services of the star are obtained from another producer the compensation is usually fixed at a weekly salary during the production period, with a provision as to a minimum number of weeks. The lending studio may charge, in addition to the weekly salary, a flat bonus or an agreed amount to cover a proportion of the retaining time or undistributed salary of the artist (frequently for a period of three weeks).

Should the star be engaged by the studio for a period of one year, it will be necessary, as previously mentioned, to determine the basis used by the studio for apportioning the star's salary to the cost of production.

Payroll records, daily call sheets and production reports should be scrutinized in testing the distribution of the salaries of stars, stock talent, outside talent and actors playing small parts or "bits."

Daily extra-talent sheets designating the names of the persons employed for each production and the daily rate or wage are prepared by the casting agencies or the studio casting office. These sheets are used as a register and as a detail of extra-talent vouchers payable by stamping the date of payment opposite each paid item. Extra-talent sheets are supported by vouchers showing the name of the production, director and payee and the daily rate. A voucher is issued in two parts to each extra, one part being a cash voucher, which is retained by the casting office, and the other part being used by the extra for identification and as a studio pass. The assistant director signs the studio pass at the completion of shooting and it is exchanged for the cash voucher which is then approved for payment by the casting office. This cash voucher when properly receipted is honored by the cashier.

Sets:

The cost of constructing sets should include the salaries of art directors, architects and draftsmen designing and working on plans, in addition to all direct labor and material used in construction.

The labor of "striking" or tearing down sets should be charged to the production for which the set was constructed. In some cases sets are not struck immediately but are allowed to stand for possible future use. When an old standing set is used in a subsequent picture, the labor and material for set maintenance, such as revarnishing floors, repainting walls and repairing damage by storm, etc., should be charged to the set cost of the new production. If at some future date an old set is struck to make way for a new set, the cost of the new set should include the striking expense.

Elaborate and expensive sets are occasionally erected outdoors on the studio lot and, being of a semi-permanent nature, are allowed to remain standing indefinitely. When this type of set is such that it appears it may be used frequently or rented to other producers in the future, only a reasonable proportion of the cost should be absorbed by the first production and the balance should be capitalized under "standing sets" to be apportioned as used over subsequent productions.

Structures built on location, not used in or having direct relation to the action of the production but built more to complete the general effect or background of the location, such as trees, rail fences, cabins, etc., are usually classified as cost of dressing locations. Miniature sets and other construction for trick shots should be classified separately under the heading "effects."

Daily time-sheets and cards and foreman's and inspectors' reports should be examined in conjunction with weekly payrolls in verification of labor, while invoices and studio stores requisitions should be inspected in support of the material charged to set construction. Comparison of the actual costs should be made with the art directors' original estimates and with the budgets.

The cost of dressing sets should be charged with the salaries of set dressers and prop men while engaged in obtaining, placing and arranging the props on a set, and with the cost of all props and draperies purchased or rented especially for a set, other than action and hand props which are referred to later. When props are purchased primarily for a production but will have some subsequent value as prop equipment, the residual value may be estimated at the time of purchase, based on probable condition and usability at the completion of the picture, and the proper proportion of the cost charged to set dressing, the balance being capitalized as prop equipment. The costs of special props manufactured within the studio are ordinarily accumulated under certain jobs, and when completed are either charged out to productions or prop equipment. The cost of damages and replacements to owned or rented props is a proper charge to set dressing. Some studios maintain separate sub-accounts for prop labor (dressing), props purchased, props rented and props manufactured.

Most of the sets are constructed inside of sound stages, and are usually artificially lighted by incandescent lamps, although arc lights are still used on large sets where they can be placed at some distance from the microphones. The lighting costs ordinarily include the salaries of electricians, outside rentals of lamps, generators and other electrical equipment, etc. Some producers charge productions with a rental for studio electrical equipment, the corresponding credit being applied as a reduction of the indirect operating expenses of the electrical department.

With the exception of the salaries of staff and cast, all expenditures of a production unit while photographing sequences away from the studio are charged to location account, which may be segregated as follows:

Rentals and cost of obtaining sites
Labor and materials for dressing sets
Transportation
Hotel and meals
Miscellaneous

As more than one site may be required, each location is identified by name and all charges pertaining to it are allocated specifically.

Cash is advanced to the unit business manager to defray the operating expenses of the company when it is out on location. When the cash advances are large it is customary for the unit business manager to open a bank account in the vicinity of the location and, wherever possible, disbursements are made by cheques, countersigned by a location auditor.

The verification of the location charges should include an examination of the expense reports and supporting data.

Effects include the cost of miniature sets, trick shots, and special processes obtained through the use of fireworks, flares, explosives, smoke pots, etc., in addition to the salaries and expenses of the scientific research department directly chargeable to negative costs.

Wardrobe:

All costumes for the actresses and all uniforms and special wearing apparel for the actors are purchased or made by the wardrobe department. The extra talent ordinarily furnishes its own modern, street and evening dress, while character wardrobe or other special costumes are supplied from the studio wardrobe stock or rented from outside costumers. The cost of costumes made in the studio includes the direct salaries of the wardrobe designer and assistants. The wardrobe account is also charged with the cost of damages and replacements of owned or rented costumes, and with all amounts paid to actors in settlement of damages to their personal wardrobe.

Action and Hand Props:

In addition to the props used to dress the sets, certain action and hand props may be purchased or rented. Props such as the following are considered action props:

Airplanes
Automobiles
Animals
Boats
Motorcycles
Food used in action
Vehicles

Repairs, maintenance and operating expenses for these props should be charged to this account. However, the salaries of riders and drivers appearing in the scenes usually are included in the cost of extra talent.

Hand props include canes, suitcases, fishing rods, guns, etc., which are carried by an actor in certain sequences, but do not include sidearms, swords or other articles not used in the action of a scene but used more to complete a costume effect.

Negative Film and Sample Print:

The cost of raw film and the laboratory charges may be subdivided as follows:

Negative raw stock
Cost of developing negative
Positive raw stock
Cost of printing positive
Cutting and editing
Special color processes
Stock scenes
Cutting silent version
Special prints and duplicate negative

Loading cards or film requisitions and cameramen's reports indicate the footage of negative raw stock chargeable to a production.

If the producer operates his own laboratory, the cost of developing, polishing and examining the negative film exposed on each production is accumulated by individual job orders which, in addition to direct labor and material, include a proportion of laboratory overhead. Laboratory reports should be scrutinized to ascertain the basis of distributing overhead. Where the negative is developed and prints are made by an independent laboratory, invoices indicating the footage of negative and positive developed and printed should be compared with cameramen's and production reports.

The salaries of negative and positive cutters and projectionists when engaged on a production are charged to cutting and editing, with the exception of work relating to the cutting of the silent version on which a separate cost is maintained. Although the editing of the cutting print is supervised by the production executives, no proportion of their salaries is ordinarily allocated to this account.

The charges to the special-color-processes account include the salaries of special cameramen, the cost of technicolor or other color negative and positive raw stock and all developing and printing expenses incidental thereto.

The cost of any complete negatives purchased for certain sequences such as scenes of parades, fires, landscape and cloud effects, etc., are classified as stock scenes.

After the negative has been cut to match the final cutting print, a sample or studio copy print is made, as well as a duping or dubbing print, which may be used in printing a duplicate negative for foreign release. Some producers include the following prints in negative cost rather than as a part of the cost of distributing:

Censorship prints
Protection or copyright prints
Feeler prints
Preview prints

Feeler prints are used for the purpose of securing opinions of representative exhibitors.

Sound Recording:

Sound recording charges may be distributed to the following sub-accounts:

Sound recording salaries
Sound track film

Processing sound track film
Waxes
Processing waxes
Repairs and supplies
Re-recording from wax to film or vice versa

The sound-recording-salaries account is charged with the labor of mixers, recorders, technicians, etc., engaged in the recording of sound simultaneously with the photographing of a scene. The direct labor of the sound department assigned to the re-recording of parts from several records to a final wax synchronized with a cut reel of film is also chargeable to this account as well as the cost of editing and assembling a completed sound track reel.

The cost of the sound track film and its processing is compiled in the same manner as in the case of negative raw stock and sample print.

The waxes are processed in the record plants of outside companies and the charges include the cost of plating the master, matrix and stamper records and the cost of pressing the records required for the use of the studio sound department.

Music and Sound Effects:

The segregation of charges for music and sound effects as maintained by one of the larger studios is as follows:

Compilation of score
Salaries of musicians working on score
Salaries of musicians working on sets
Mechanical sound effects
Clearance and copyright of music
Supervision salaries
Operating expenses
Distribution of idle time of permanent musicians

The cost of compilation of score includes the salaries of song writers, scorers, composers, arrangers or orchestrators, librarians and proofreaders.

The clearance and copyright account is charged with the amounts paid for music or song rights, licenses, library of congress and foreign copyright fees, legal fees, etc.

Supervision salaries and operating expenses are charged respectively with an apportionment of the indirect salaries and expenses of the music department. It is inconsistent to treat the overhead of the music department as a direct cost of productions —however, the matter is relatively unimportant.

All idle time of musicians, composers, song writers and orchestrators employed permanently is divided equally between productions actually being scored during each day.

Other Charges:

All other expenses directly chargeable to a production may be classified under the following sub-headings:

Transportation
Titles and inserts
Stills
Camera expense
Meals (other than on location)
Insurance
Miscellaneous

The item of transportation represents all such charges not relating to the cost of transporting a production unit and equipment to and from location. However, some producers distribute all transportation charges over various sub-accounts wherever a direct allocation is possible. For example, the cost of transporting studio and rented props is included under set dressing, the transportation of electrical equipment is charged to lighting of sets and the traveling expense (except to and from location) of the star are distributed to salaries and expenses of the cast.

The use of titles and inserts has been largely restricted to the titling of the silent version of a talking picture and these costs comprise the salaries of title-writers, the direct labor and material of the title department in preparing and photographing the title cards, and also the cost of any complete titles which are purchased.

The cost of stills is usually made up of the salary of the still cameraman, together with the cost of the negative and positive film and the charges for developing and printing.

Camera expense covers the cost of camera platforms and tracks when constructed for a specific production, camera slates, camera repairs, the rental of special lenses or additional cameras, etc.

Productions may be charged directly with the cost of negative floater, compensation or life insurance. Premiums on negative floater are usually charged to general studio overhead. In some cases, premiums on compensation insurance are included in the labor distribution, while the premiums on life-insurance policies covering stars or featured actors are usually charged to the salaries and expenses of the cast.

Overhead:

As previously mentioned all the indirect expenditures of the studio are accumulated in overhead accounts before being distributed to productions. There is even less uniformity in the classification of detail overhead accounts used by the producers than in the case of individual picture costs. However, all detailed accounts may be grouped under the following general headings:

1. Salaries and expenses of executives.
2. Indirect salaries and expenses of operating departments.
3. Salaries and expenses of other departments.
4. Retaining time of actors, directors, supervisors, etc.
5. Plant expense.
6. General expense.
7. Miscellaneous income.

The operating departments comprise all departments having a part in the actual production of a picture, such as the scenario, prop, wardrobe or cutting departments. Separate sub-accounts should be maintained for each of the various operating departments, which should be charged with the portion of salaries and expenses not directly chargeable to productions. Separate sub-accounts should also be maintained for the accounting, purchasing, legal and other "non-operating" departments.

As previously mentioned it is the practice of some studios to carry the undistributed retaining time or suspense salaries of actors, directors, supervisors, etc., (still under contract) as a deferred charge against future productions, while other producers charge all idle time to overhead. Irrespective of the method used in distributing retaining time there are always some charges which must be absorbed in overhead. Contracts are frequently terminated on short notice, or actors have not been employed for some time prior to date of termination of contract, so that the unabsorbed balances can not equitably be distributed to completed productions. There have been instances in which contracts have been terminated long before the expiration dates and settlements have been made upon the payment of relatively large sums of money. In these cases the amounts were transferred to the home office to be absorbed in the general accounts of the company.

Plant expense comprises:

Power, light, heat, and water
Repairs and maintenance
Depreciation
Salaries and wages of janitors, cleaners, watchmen, special police and firemen

The rates used by studios for depreciating buildings and equipment are in general very conservative. Since the advent of talking pictures, new sound stages have been constructed and the majority of the old stages either have been "sound proofed" or remodeled and used for other purposes. The following summary sets forth some of the rates in use at representative studios:

	Percentage per annum		
	A	B	C
Buildings:			
Stages	10	8	8
Other:			
Stucco	10	8	6–8
Concrete	2½	8	4
Equipment:			
Automobiles and trucks	25	25	20
Cameras	20	25	10
Cutting room	20	10	15
Electrical	20	25	10–15
Fire apparatus	20	10	15
Furniture and fixtures	10	10	10
Laboratory	20		
Library		25	
Machinery and tools	20	15–50	20
Projection	20	20	10
Props	33⅓	25	15
Restaurant		10	
Sound	33⅓	50	15
Still room	25	25	15
Stock sets	66⅔	50	
Wardrobe and draperies	66⅔	50	15

General expense includes:

Taxes, licences, etc.
Insurance—compensation
Insurance—fire
Scenarios written off
Charges to released productions
Telephone and telegraph expense
Legal and audit fees
Stationery and office supplies

Postage
Inventory adjustments
Miscellaneous expenses

The status of unused stories, books and scenarios should be reviewed periodically, and when the production executives decide that any material is unsuitable for use in future pictures, the cost of it should be charged to studio overhead.

Miscellaneous delayed small direct charges to released productions are usually charged to overhead and are not treated as an adjustment of the previously established studio cost.

All legal and audit fees incurred by the studio are properly chargeable to the cost of productions and should not be included in home-office expense.

Interest on studio obligations is not generally included in the cost of productions.

Any profit realized on the loan of employees to other producers, rentals of standing sets, electrical equipment, props, wardrobe, etc., are generally reflected in miscellaneous income which is treated as a reduction of the general expenses.

The distribution of general overhead is a moot question in studio cost accounting and is open to varying opinions and theories. The following are, however, the more commonly used methods of distributing overhead to pictures:

1. On basis of percentage of direct cost.
2. Actual overhead for each week distributed equally to the productions in process.
3. Total overhead for year distributed equally to pictures completed.

The first method, with numerous modifications, is the one most frequently used as it is generally recognized that there is a direct relation between the direct cost of a picture and the indirect expenses of operating a studio.

Special feature productions ordinarily use a greater proportion of the studio space and facilities and require considerably more of the attention of the studio executives than the ordinary programme pictures, which may be in process for almost the same length of time. For instance, a production with direct costs of $150,000 may take four weeks to complete, while a superfeature with direct costs of $600,000 may be completed in five or six weeks.

In determining a percentage to use, the overhead for a year is estimated by comparison with the actual indirect expenses of the preceding period, and this amount is divided by the estimated total direct costs of pictures on the new production programme, based upon budgets approved by the head office. In making plans for a new programme, the head office usually decides that an approximate amount of say $12,500,000 will be spent on a specified number of pictures, and budget figures are estimated roughly for each picture. If the total amount to be expended is estimated at $12,500,000 and the estimated overhead is $2,500,000, the overhead rate would be 25 per cent. of the remaining estimated direct costs of $10,000,000.

The percentage adopted should provide a margin for safety and should be reviewed frequently. If it is ascertained that the ratio of the actual indirect expenses to direct charges is not in agreement with the estimate the rate should be revised accordingly. The estimates are also used by the studio officers in an endeavor to effect economies in the operation of the various departments.

The success of the percentage method of distributing overhead depends largely upon whether or not drastic changes are made in the original production schedule. The experience of one studio may be cited as an illustration of a drastic curtailment in the production schedule, where only fourteen feature pictures were produced as compared with thirty on the original programme, resulting in an arbitrary adjustment of a substantial amount to each of the completed productions. The necessity for such arbitrary adjustments emphasizes the fact that care should be exercised in determining the percentage to be used and that frequent revisions in the rate, based upon revised estimates of the studio expenses, should be made in order to prevent a large accumulation of undistributed overhead. The usual practice is to distribute any large accumulation of overhead charges equally to a number of pictures, but it would be more consistent to make such a distribution on the basis of a percentage of direct costs.

There are numerous modifications of the straight-percentage-of-direct-cost method. Some producers load the direct costs with the indirect expenses of certain operating departments, such as the sound or transportation department, while other producers load direct costs with the expenses of all operating departments, any under-absorbed or credit balances being carried forward against the next year's operation. The loading charges may vary, depending upon the specific department. For example, loadings for the electrical and prop departments may be made on the basis of rentals at outside rates, the construction department expenses may be allocated by a flat surcharge of 10 per cent., while the expenses of the still department may be distributed on a billing or sales basis. Mechanical supervision may be charged at a flat amount per picture. Further modifications are made by some producers, who charge a smaller percentage of overhead to productions made largely on location than to the pictures produced almost entirely within the studio. Other producers do not add overhead to the cost of stories or story rights on the theory that these costs were not incurred as a result of the operation of the studio. Where an original story has been developed within the studio it would appear proper to include overhead on such an item of cost.

One of the larger producers uses the second method, wherein all indirect expenses of the studio each week are distributed equally among the pictures then in process. The argument is advanced that this method precludes the accumulation of undistributed overhead, necessitating arbitrary adjustments, and also that the superfeature pictures are in production for a greater length and therefore absorb more overhead than the programme pictures. It so happens that this producer has not been operating a full twelve months each year and the overhead accumulation during the shut-down period is arbitrarily pro-rated between a number of pictures on the completed programme and certain productions on the succeeding year's programme. The relative length of shooting time required for programme, feature and superfeature productions at this studio together with the resultant percentage of overhead to direct charges may be compared in groups by the following summary of 35 completed pictures:

Group number	Number of productions	Total production cost	Camera days	Approximate percentage of indirect charges to direct charges
1	11	$50,000 to $145,000	11–24	48% to 130%
2	11	150,000 to 300,000	21–49	25% to 54%
3	3	300,000 to 400,000	25–32	17% to 24%
4	6	405,000 to 490,000	30–53	18% to 26%
5	1	500,000	42	20%
6	3	600,000 to 750,000	27–51	13% to 17%
	35			

If we compare groups 2 to 6 it will be seen that there is no apparent relation between the total production cost and the number of camera days or length of the shooting period. The resultant average percentage of the total indirect charges to the total direct charges of the thirty-five productions was 27.197 per cent.

The foregoing table may be supplemented by the following information showing the fluctuations in percentages as between specific pictures:

				Percentage of indirect charges to		
Production	Total cost	Direct charges	Indirect charges	Direct cost	Total cost	Camera days
1	$745,000	$660,000	$85,000	13.0	11.4	51
2	670,000	587,000	83,000	14.0	12.4	27
3	470,000	372,000	98,000	26.4	21.0	53
4	465,000	386,000	79,000	20.5	17.0	32
5	300,000	226,000	74,000	33.0	24.6	49
6	200,000	130,000	70,000	54.0	35.0	34
7	190,000	152,000	38,000	25.0	20.0	37
8	135,000	72,000	63,000	88.5	47.0	14
9	135,000	59,000	76,000	130.0	56.4	15

The fluctuations are due mainly to the difference in number of pictures in process at given periods. For example, production number 9 was produced at a time when no other pictures were in process, whereas only one or two other pictures were in process during the shooting of production number 8.

The method of distributing overhead equally to all productions completed during any one year is used by producers of short length pictures or where a series of pictures is produced at approximately the same cost. The basis appears equitable, as these types of pictures usually require about the same studio facilities and supervision and ordinarily are completed within the same length of time. The overhead is projected in the usual manner and the estimates are adjusted to the actual at the end of the production year.

Certain producers specialize entirely in the production of one superfeature at a time, which may require approximately a year to complete. All indirect charges during the production period are charged to the picture. Indirect charges subsequent to the completion of a picture customarily are distributed to the next production to be made, although in one company all indirect expenses during the year are charged direct to profit and loss.

In addition to the above methods now in use, some mention should be made of the camera-day basis, formerly in general use for distributing studio overhead. An estimate was made of the total number of camera days for the new programme, which was divided into the total estimated overhead for the year in computing an estimated rate per camera day. This rate was applied to each picture on the basis of the actual shooting period. The main disadvantage of this method was that while overhead charges could be accurately estimated, the estimate of total camera days could not be revised with any degree of accuracy until near the end of the production year because there might have been variations in the shooting time of each picture or the production programme might have been shortened.

Producers Renting Studio Facilities

The principal difference between the production costs of producers renting studio facilities and those who operate their own is that the renting producer has a relatively small percentage of overhead expenses. Charges for rentals covering use of stage space, facilities and equipment, sound stages and recording equipment are made against specific pictures as direct items of cost. Supervision of the studio operating departments is customarily provided for by charging the tenant a flat 10 per cent. on all labor and material furnished. Sets are either constructed specifically for the picture or a direct rental charge is made. The overhead of the renting producer consists mainly of administrative and office expenses.

Contracts frequently stipulate that the charges for the use of sound stages, recording and other equipment, etc., shall be based upon prevailing rental rates in Hollywood. Conditions in Hollywood are changing continually and in actual practice there are no rates which can be termed as prevailing. It is therefore desirable that definite contracts or arrangements be made to cover specific cases.

Scope and General Methods of Verification of Production Costs

The scope of the examination naturally depends upon the instructions received. They may call for:

1. Examination of production costs in balance-sheet audits.
2. Certification of cost of one or more pictures.
3. General examination of specific productions.

Most of the examinations of studio accounts are made in periodical balance-sheet audits, and consequently verification of production costs is necessarily limited to various tests. In addition to the verification of the other assets and liabilities of the studio which tend to substantiate the general accuracy of the production accounts, the following specific tests should be made:

1. Production costs for specific weeks selected at random verified in detail.
2. The costs of specific productions verified in detail.
3. Certain subdivisions of costs verified in detail. The sub-accounts selected should vary from one examination to another.

In conjunction with these tests, which may be combined, all detail picture-cost statements should be scrutinized and all large and unusual charges should be verified in detail.

Some producers maintain daily picture costs as an integral part of the accounting system, while others maintain only memorandum daily costs. In the first case it is necessary to examine the detail daily cost records which greatly increases the necessary work of verification. As an example, one-sixth of all weekly salaries is posted each day. In the second case it is necessary to examine only detail production records, which are posted weekly. This practice permits more comprehensive tests to be made within a given period of time.

When verifying the cost of one or more pictures it is necessary to examine all charges in detail and, as previously mentioned, to ascertain the basis used in distributing retaining time of employees under term contracts, and all overhead charges. These productions are usually produced under the terms of contracts which may or may not be profit sharing. As a general rule these contracts are prepared by the home office and, while definite as to distribution charges, are indefinite as to the items and amounts to be included in production cost. The direct charges are not sufficiently defined. Rarely does a contract specify a maximum amount for overhead or even provide for a definite percentage to be applied on direct costs. In certifying picture costs in such circumstances, the certificate should be qualified with reference to all items of cost where any doubt as to the propriety exists.

General examinations are sometimes made of specific productions being released under distribution contracts, with actual or certain maximum cost figures stipulated as the turning point for percentages to be shared by producer and distributor. The instructions in such cases should be definite and the verification should comprise an analysis of all larger subdivisions of cost, the examination of all contracts and various comprehensive tests.

Accounting Problems of the Unincorporated Investment Trust

By Gabriel A. D. Preinreich

That this article was written at all is due largely to accident. In the course of a regular audit, I was requested by a client to explain the contents of a printed report on the affairs of a certain trust described as an accumulative fund. In the opinion of the client, the report contained several contradictions and utterly failed to satisfy his very natural curiosity on two points:

1. How was it possible for the fund to close its operations with a huge profit notwithstanding the fact that he had just been notified of a reduction in the value of his certificate and of the amount of his losses deductible for income-tax purposes?
2. How could he determine from the audited income account presented in the report whether the notification received was correct or not?

The trust in question is of the management type and consists merely of a fund contributed by holders of non-negotiable certificates. Control and custody is vested in a manager and a trustee respectively, the certificate holders' rights being limited to the privilege of calling for the redemption of their certificates at the end of any calendar week.

Since I was inclined to agree with the client, at least in part, it has occurred to me that a brief study of the problems confronting such trusts and an independent attempt to solve them, might be timely and lead not only to fruitful discussion but to a gradual standardization of the still somewhat untried accounting procedure used by a form of financial enterprise which is steadily gaining in public favor.

The main advantages of the unincorporated investment trust over its corporate kin consist of greater ease and flexibility in organization and management and the fact that it is not subject to federal or state income taxes in any form whatever, each certificate holder being taxed exactly in the same manner as though he had been personally engaged in buying, holding and selling securities to the extent of his participation in the total fund.

This, undoubtedly, is an advantage, which, however, is offset by certain disadvantages springing from the same source.

Corporations are not burdened with the redemption of their stock, nor do stockholders have to report income unless the corporation pays dividends. The unincorporated trust must be able to determine the exact redemption value of its certificates on each redemption date and must advise the certificate holders of their shares in as many as seven or eight different kinds of income, not only annually, but whenever they elect to retire from the trust. Certificates issued during the year must be sold at their exact value as of the date of issue and income accumulated thereon for the remainder of the year must be determined correctly to safeguard each holder's individual interests. If we add that good accounting procedure requires that the lower of cost or market be used as the basis of investment valuation, whereas admissions and redemptions are closed at market values, and if we further remember that cost for tax purposes is not always equal to cost, we have a fair picture of the difficulties besetting the bookkeeper of the unincorporated trust, from all of which his more fortunate confrère working for a corporation is happily exempt.

The principal accounting problems of the unincorporated trust may therefore be summarized as follows:

1. The exact financial condition of the trust must be known as of each date of admission or redemption.
2. Such financial condition must be stated on three different bases, namely:
   (a) Cost as defined by income-tax regulations.
   (b) The lower of cost or market, as defined by correct accounting procedure.
   (c) Market.
3. Income must be segregated into the following classes:
   (a) Profit on sale of securities.
   (b) Capital gain on sale of securities.
   (c) Dividends of domestic corporations.
   (d) Dividends of foreign corporations.
   (e) Interest on tax-exempt bonds.
   (f) Interest on bonds (tax paid at source).
   (g) Interest (fully taxable).
   (h) Non-taxable income arising from differences between income-tax regulations and accounting procedure.

4. The proportionate amounts of each class of income due each shareholder must be readily available on each balance-sheet date, with due consideration for fractional periods reducing the shares of holders who:
   (a) Joined after the beginning of the year.
   (b) Retired before the end of the year.
   (c) Joined after the beginning and retired before the end of the year.
5. Compensation due the management and the proportionate amounts thereof chargeable against each certificate holder must be ascertainable to the same extent as income.

At first sight, this appears to be a large order, but it may be noted that, after all, the number of general-ledger accounts required is not large. The balance-sheet will, in all probability, list the following items:

I. Assets:
   1. Cash on deposit.
   2. Call loans.
   3. Securities long (at cost).
   4. Unrealized market appreciation of securities long.
   5. Accrued interest receivable.
   6. Accrued preferred dividends receivable.
   7. Common dividends declared.

II. Liabilities:
   1. Brokers' balances.
   2. Securities short at selling price.
   3. Market appreciation of securities short.
   4. Management compensation payable.
   5. Subscriptions to certificates not issued.

III. Capital:
   1. Certificates outstanding.
   2. Surplus.
   3–10. Income of current year.
   11. Unrealized profits.

The foregoing list makes allowance for a broader scope of operations than will be conducted by the average investment trust. Accounts used for trading on margin may probably be dispensed with, as well as several of the income accounts, since investments may well be limited to common stocks of domestic corporations. The list was made comprehensive to show the flexibility of the system outlined in the following paragraphs, which makes it adaptable to the needs of different classes of investors.

Since the number of accounts is small and accountings must be rendered frequently, it becomes apparent that the record best suited for the purpose is a columnar book combining the functions of cashbook, journal, general ledger and trial balance, the size of which will be reduced to the limit by avoiding the cumbersome distinction between debit and credit columns through the use of red ink for credits or some similar arrangement. For the sake of clarity the record proposed is reproduced in exhibit A in its simplest form. Examples of transactions occurring in the course of regular operations are entered and will be discussed in the order recorded.

Opening entry Sept. 1, 19...		
Cash	$1,000,000.00	
To certificates outstanding		$1,000,000.00
Details are posted to a subsidiary certificate ledger in the usual way.		
Purchase of securities Sept. 1:		
Securities owned	977,750.00	
To cash		977,750.00
Details are posted to the subsidiary investment ledger.		
Interest received Sept. 30:		
Cash	55.62	
To interest on bank balance		55.62
Sale of securities, Oct. 3:		
Cash	153,250.00	
To securities owned (cost of 1,000 U. S. Steel)		147,750.00
Profit on sale		5,500.00

The capital gain column will be used in all cases where securities were held over two years. In the final or annual accounting to certificate holders the capital gain is transferred to profit on sale for all holders whose certificates were issued less than two years before sale of the investment.

Money lent on Call, Oct. 3:

Call loans..................	$150,000.00	
To cash.................		$150,000.00

Interest received, Oct. 31:

Cash......................	59.80	
Call loans..................	1,050.00	
To interest...............		1,109.80

Accruals to close books, Nov. 3:

Accrued interest on bank balance..................	6.40	
Accrued interest on call loans	112.50	
Dividend receivable.........	10,500.00	
To interest...............		118.90
Dividends...............		10,500.00

Management compensation, Nov. 3:

The fee payable to the management is the only expense of the trust. It may be computed in various ways, such as:

1. Fixed amount per month.
2. Percentage of income.
3. Percentage of market appreciation of securities.
4. Percentage of net worth.

In exhibit A the fee equals $\frac{1}{101}$ of the face value of certificates issued and $\frac{1}{101}$ of income and unrealized market appreciation. The former is not returnable upon redemption of the certificates; the latter, however, is charged back to the management if losses are subsequently suffered. The results of the computation may best be observed in exhibit B. Since the illustration is that of a trust in its first period of operation, the fee includes the original levy on capital. The correctness of the amount charged may be proved as follows:

A. White—December 31, 19...		
Certificates outstanding........	$500,000.00	
Profit on sale and interest......	11,472.79	
Dividends....................	5,250.00	
Non-taxable income...........	2,128.32	
Unrealized appreciation........	21,052.63	
		$539,903.74
Management expense 1%......		5,345.58
Equity 100%................		$534,558.16

Unrealized market appreciation, Nov. 3:

Only a memorandum entry is made, supported by a list of securities priced at both cost and market as of the close of the day.

Issue of additional certificates, Nov. 4:

The price at which new certificates must be issued is determined by dividing the total equity, including unrealized market appreciation on securities, by the number of old certificates outstanding. The total to be paid by the new entrant is then computed in the following manner:

n_o = Number of old certificates outstanding.

E_o = Net worth including unrealized market appreciation at the close of the day as of which new shares are to be issued.

$$\frac{E_o}{n_o} + \frac{100}{101} = \text{Cash price of 1 new certificate.}$$

Using this formula for the computation of the entry shown in exhibit A, we have

$$\frac{1.106.222.10}{10.000} + \frac{100}{101} = 111.61231$$

The issue of 500 shares is therefore recorded in detail as follows:

Cash........................	$55,806.15	
Management compensation.....	58.06	
To certificates outstanding...		$50,000.00
Surplus.................		....
Profit on sale and interest		339.21
Capital gain............		......
Dividends..............		525.00
Non-taxable income......		5,000.00

Postings are made to the income accounts of the general ledger and to the certificate ledger as shown in exhibit B. The posting of new contributions to income distorts the actual earnings of the trust, but it simplifies the computation of individual incomes.

For the benefit of the reader inclined to be skeptical about such an innovation it may be well to recall the case of the cadi of *Arabian Nights* who had to execute the will of a man who died leaving three sons and nineteen camels. The will provided that one half of the camels was to go to his eldest son, whereas the two others were to receive one fourth and one fifth respectively. As may be remembered, the cadi solved the baffling problem by directing his attendant to lead his own camel alongside the others. The division was then effected smoothly by allotting 10, 5 and 4 camels respectively, to the three heirs, and the cadi's camel, left over, was returned to its grazing place.

That is about what is proposed here. Further explanation and algebraic proof of the correctness of this procedure is furnished in a later paragraph. The payment made for the new entrant's proportion of the unrealized market appreciation was included in non-taxable income for reasons discussed under that caption. Just what such a contribution really represents may be determined as follows:

M = Unrealized market appreciation.

n_o = Number of old certificates outstanding.

n_e = Number of new certificates to be issued.

$\frac{M}{n_o}$ = Unrealized appreciation owned per old certificate and therefore to be contributed by each new certificate.

$\frac{n_e M}{n_o}$ = Total payment of new entrants for unrealized market appreciation.

$\frac{M}{n_o+n_e}$ = Unrealized appreciation owned per certificate after admission of new entrants.

$\frac{\frac{n_e M}{n_o}}{n_o+n_e} = \frac{n_e M}{n_o(n_o+n_e)}$ = Market appreciation realized by each old certificate.

The admission of a new entrant, therefore, amounts to the sale of the security holdings to the extent of the expression $\frac{1}{n_o} - \frac{1}{n_o+n_e}$

for cash, and to the realization of that proportion of the market appreciation.

If, therefore, the amount of $\frac{n_eM}{n_o}$ is paid in, that amount may be properly posted to profit on sale or capital gain, since it represents appreciation converted into cash to the extent of $\frac{n_eM}{n_o+n_e}$ and a contribution of new entrants to match that gain in the amount of $\frac{n_e^2M}{n_o(n_o+n_e)}$.

$$\frac{n_eM}{n_o}=\frac{n_eM}{n_o+n_e}+\frac{n_e^2M}{n_o(n_o+n_e)}$$

Redemption of certificates, Dec. 9:

The amount to be paid to certificate holders wishing to retire from the trust is similarly determined by first recording all accruals and dividing the sum of book equity and unrealized market appreciation by the number of certificates outstanding. Conversely to the issue of certificates, a redemption may be considered the purchase by the remaining certificate holders of the retiring holders' interest in securities owned. The price paid for that interest in excess of the book value is therefore an addition to cost rather than a distribution of income, since the income so distributed has not been realized as yet.

$\frac{M}{n_o}$ = Portion of market appreciation owned by each certificate.

n_r = Number of certificates to be redeemed.

$\frac{n_rM}{n_o}$ = Portion of market appreciation due to retiring members.

$\frac{M}{n_o-n_r}$ = Portion of market appreciation per remaining certificate.

The amount of unrealized market appreciation purchased for cash or the additional cost of securities owned will, therefore, be

$$\frac{M}{n_o-n_r}-\frac{M}{n_o}=\frac{n_rM}{n_o(n_o-n_r)}$$

Apart from this addition to cost, each remaining certificate holder will also own a larger portion of the portfolio than before; this increase, however, is reflected by the increased number of shares held per certificate, not by an increase in the cost price, and is offset by a corresponding decrease in cash.

The solution appears to be correct from the strictly mathematical and theoretical point of view, but it gives rise to doubt as to the conservativeness of the procedure. Suppose for instance, that equal numbers of certificates are issued and retired on the same day. The result would be to charge cost and credit profit on sale by

$$\frac{n_e M}{n_o} = \frac{n_r M}{n_o}$$

although none of the old holders is actually affected. By placing

$$n_o = n_r = n_e$$

it would be possible to imagine that all the certificates were constructively retired and immediately reissued, whereupon the unrealized market appreciation would suddenly be realized.

It may therefore be better practice to charge the portion of unrealized market appreciation to profit on sale as a distribution of profits which, it must be hoped, will ultimately be credited to that account. This procedure will meet no opposition, when the trust is of the accumulative type, paying no distributions whatever, except upon redemption of its certificates. If, however, income is regularly distributed, zealous protagonists of the propriety of increasing cost will no doubt arise. Their best argument is that the trust has no separate entity distinct from its members and that, therefore, changes in the value of individual equities are actually realized at each bona-fide issue or redemption of certificates.

NON-TAXABLE INCOME ARISING FROM DIFFERENCES BETWEEN INCOME TAX REGULATIONS AND ACCOUNTING PROCEDURE

The first item to be considered under this heading is the realization of market appreciation which takes place upon the issuance of additional certificates. It may be said that the case is similar to that of admitting a new partner. In accordance with established precedent, the old partners are not liable for income taxes on their proportion of the excess paid in until the assets to which the increased value attaches have been sold. The question at issue is merely: When does realization really take place? The tentative inclusion of the item in non-taxable income for the purpose of this essay should not be interpreted as a definite answer to this question, which is really outside the scope of this discussion. Its inclusion in surplus might be just as proper, but it would complicate the technique of the annual closing. The creation of a special capital-surplus account should not be considered, since all income accounts are already distorted by the inclusion of capital items.

The excess over book value paid for redeemed shares is the second item tentatively recorded in this account, although, for purposes of the retiring member it must, of course, be transferred to taxable income (see F. Brown's account in exhibit B). So far as the remaining holders are concerned, the amounts so disbursed might be described as the exchange of realized profits for unrealized ones, and the continuous writing up of cost may well result in inflation beyond the market price prevailing at a later date.

Another discrepancy between income-tax regulations and accounting procedure will be found in the treatment of stock dividends. Without wishing to pass upon the merits of other opinions held upon this subject, the writer believes that, *Eisner* v. *Macomber* to the contrary notwithstanding, a stock dividend declared from surplus earned after the acquisition of the stock represents realized income at least to the extent of the recipient's proportion of the amount transferred from surplus to capital stock by the issuing company. The exception applying to the case of parent companies which record the stock of subsidiaries at their respective book values must, of course, be recognized.

The entry shown in exhibit A uses the well known illustration of the North American Company, which transfers $10.00 a share from surplus to capital stock upon issuance of its quarterly 2.5% stock dividends. If a considerable part of the equity were invested in the stock of this company, the trust would be unable to pay distributions commensurate with earnings, unless the correctness of the income theory were recognized. That some of the dividend stock may have to be sold in order to make cash distributions possible is readily admitted, but whether such a course of action is in the best interests of the trust or not is a question of investment management rather than accounting theory.

The journal entries will be as follows:

Upon declaration:

Dividends declared	$250.00	
To non-taxable income		$250.00

Upon receipt:		
Securities owned	$250.00	
To dividends declared		$250.00
Upon sale:		
Cash	2,325.00	
To securities owned		250.00
Profit on sale		99.39
Non-taxable income		1,975.61

The last entry is computed in accordance with income-tax regulations:

1,000	shares	cost	$91,250.00
25	"	"	....
1,025	"	"	91,250.00
1	"	"	89.02439
25	"	"	$2,225.61
25	"	sold for	2,325.00
Taxable profit			$99.39

The entries seem theoretically correct, whenever the common stock is diluted at a lower rate than the rate of earnings upon the entire equity of common stockholders and so long as the long-term trend of market values remains a constant multiple of annual earnings. All these factors have been present so far in the case of the North American Company. Strictly speaking, a further qualification must be made to the effect that if the stock was purchased at a higher cost than the constant multiple referred to, the excess purchase price must be amortized out of the proceeds of stock dividends sold.

If the procedure outlined is followed, careful memorandum records must be kept with respect to the difference in cost according to the books and cost for income-tax purposes. The proper proportion of this difference must be transferred from non-taxable income to profit or capital gain on sale, when part of the original stock is sold.

Closing, Dec. 31:

When a certificate is issued, the consideration received is entered in detail in the subsidiary certificate ledger (exhibit B). Upon redemption, the price is posted in a similar manner. The difference between the two entries is the amount to be reported as income. At the annual closing, the balance of each income account in the general ledger is divided by the number of shares outstanding and multiplied by the individual holdings. The results so obtained are again posted to the certificate ledger, whereupon the accounts are balanced to obtain the income to be reported by those who were members of the trust at the end of the year.

Attention has already been called to the fact that the closing balances of the income accounts do not reflect the income of the trust, but, since additions and deductions arising from changes in the number of certificates outstanding were always in proportion to the respective equities, those balances divided by the number of certificates outstanding at the end of the year will equal the amount earned by a certificate for the entire year. Algebraic proof of this may be furnished as follows:

Let us assume that at some time after the beginning of the year, new certificates were issued and then, after a second period had elapsed, other certificates were redeemed. This divides the year into three periods symbolized as follows:

	Number of cert. outstanding	Income for period
First period..................	n_o	i_o
Second period................	n_o+n_e	i_e
Third period..................	$n_o+n_e-n_r$	i_r

The income of a certificate held throughout the year is:

$$\frac{i_o}{n_o}+\frac{i_e}{n_o+n_e}+\frac{i_r}{n_o+n_e-n_r}$$

In actual practice, this expression would attain considerable length, since admissions and redemptions occur weekly or even daily. Let us now add the proportionate share of each entrant to the income already earned. The balance of the income account will then be:

$$i_o+\frac{n_e}{n_o}i_o+i_e-\frac{n_r}{n_o+n_e}\left(i_o+\frac{n_e}{n_o}i_o+i_e\right)+i_r$$

or simplified:

$$\left(i_o\left(1+\frac{n_e}{n_o}\right)+i_e\right)\left(1-\frac{n_r}{n_o+n_e}\right)+i_r$$

This expression, divided by $n_o+n_e-n_r$ yields the original formula for the income of one certificate held throughout the year, thereby furnishing the proof required:

$$\frac{\left(i_o\left(1+\frac{n_e}{n_o}\right)+i_e\right)\left(1-\frac{n_r}{n_o+n_e}\right)+i_r}{n_o+n_e-n_r}=\frac{i_o}{n_o}+\frac{i_e}{n_o+n_e}+\frac{i_r}{n_o+n_e-n_r}$$

It may, therefore, be seen that by surrendering the largely imaginary advantage of having the books reflect the total income of the trust, a convenient base is derived for the quick computation of each certificate holder's individual income, without the cumbersome procedure of posting profits to every account, whenever there is a change in one or the not much less cumbersome alternative of keeping separate income accounts for each succeeding partnership, of which there may be 52 or even 300 a year.

At the end of the year, when the certificate ledger is closed, the total of the individual incomes to be reported will give the total income of the trust. The proof of this total may be obtained as follows:

Certificates outstanding at end		$950,000.00
Surplus after closing		25,660.50
		$975,660.50
Less: Certificates outstanding at beginning		
Surplus at beginning		
Transactions in certificates for period	$950,249.36	
		950,249.36
Income of trust		$25,411.14

The trial balance of the certificate ledger showing this reconciliation is reproduced in exhibit B. In order to facilitate the procedure, it is advisable to use a separate column in the general ledger for cash transactions affecting certificates. This column will act as a controlling account for the certificate ledger throughout the year. The bank balance must, obviously, reconcile with the algebraic sum of the two cash columns.

STATEMENTS FOR CERTIFICATE HOLDERS

With the routine of bookkeeping disposed of, we may now return to the question: What information is most interesting to the certificate holder? In general, the data may be grouped under three headings:

1. Balance-sheet and supporting schedules;
2. Income account;
3. Comparative statistical data.

The information conveyed by the balance-sheet is especially needed when certificates are issued or redeemed. When we buy or sell something, we are more interested in values than at any other time during the period of ownership and it is only natural that we should like to see a bill of sale itemizing the details of the transaction. If the client mentioned earlier in this article had received a balance-sheet as of the date he acquired his certificate (on or about September 1, 1929), a comparison of the figures with the closing balance-sheet as of December 31, 1929, would have answered his query, even though the unpleasant subject was avoided in the report, which stressed the success of operations for the year 1929. We may say therefore, that no trust of the kind described is organized with due regard to the wishes of its certificate holders, if its accounting system cannot produce a balance-sheet correct to the last detail upon the shortest notice, or if it fails to furnish that information to every certificate holder at least:

1. As of the day of purchase;
2. Quarterly;
3. As of the day of redemption.

The form of record shown in exhibit A is a perpetual balance-sheet, ready to furnish the exact figures at the close of any business day. For example, a balance-sheet for the use of H. Greene, Esq., may be prepared as follows:

THE UNINCORPORATED INVESTMENT TRUST

Comparative balance-sheet for H. Greene, Esq.

	November 3	December 8	Increase *Decrease*
Cash	$ 25,615.42	$ 38,638.80	$13,023.38
Call loans	150,000.00	400,000.00	250,000.00
Accrued interest receivable	1,168.90	3,656.64	2,487.74
Dividends receivable	10,500.00	10,500.00	....

Securities owned (at cost).....	$830,000.00	$682,250.00	*$147,750.00*
Unrealized appreciation on securities.....................	100,000.00	50,000.00	*50,000.00*
	$1,117,284.32	$1,185,045.44	$ 67,761.12
Less: Management fees payable	11,062.22	1,717.16	*9,345.06*
	$1,106,222.10	$1,183,328.28	$ 77,106.18
Certificates outstanding (par 100)......................	$1,000,000.00	$1,100,000.00	$100,000.00
Surplus: Realized............	6,222.10	33,328.28	27,106.18
Unrealized...........	100,000.00	50,000.00	*50,000.00*
	$1,106,222.10	$1,183,328.28	$ 77,106.18
Value of 500 Certificates......	$ 55,311.10	$ 53,787.65	
Management fee paid.........	495.05		
Total....................	$ 55,806.15	$ 53,787.65	*$ 2,018.50*

It will probably be unnecessary to furnish a detailed schedule of securities owned, except upon special request.

The income account of the report referred to is fairly representative of several others. It is a copy of the old-fashioned profit-and-loss account, with all the emphasis upon the earnings of the trust and scant regard for the individual owner. In the comments upon income figures there occurs this statement:

"As subscriptions to the accumulative fund were received continuously throughout the year ended December 31, 1929, the income and unrealized profits on securities held as reported in statement 2 are not properly applicable to the face value of certificates outstanding at the end of the year. The following tabulation is therefore designed to disclose the rate per cent. per annum on the average face value of certificates outstanding during the year."

(Table omitted)

"It should, however, be borne in mind that the rates per cent. per annum upon face value in the above tabulation relate only to a theoretical average certificate."

That describes the matter very well. In other words, no certificate holder, even though he may have been a member of the trust for the entire year, is in a position to find out from the audited income account how much his holdings earned, in order to verify the accuracy of the statement received from the trust to attach to his income-tax return. (N.B. The earnings of the theoretical average certificate as described would be equal to those of a certificate held throughout the year only if the income had never varied from a constant percentage of the changing equity. This, however, was obviously not the case in 1929, when huge profits were made in the first three quarters, only to be lost during the fourth.)

The income account, therefore, is of little practical value, except as a bookkeeping device for the reconciliation of surplus at the beginning and end of the year. What the certificate holder looks for in an annual report is the appreciation of a certificate held throughout the year, with at least quarterly if not monthly subdivisions, so as to permit a rough approximation of the increase in the value of his investment for the period the certificate was actually held. The next question of interest would be: What part of that appreciation is realized and how much of it represents paper profits?

As already pointed out, the amount earned by a certificate held throughout the year is obtained by dividing the footings of each income account in the general ledger by the number of certificates outstanding at the end of the year and summarizing the result. Unrealized market appreciation was recorded as a memorandum and may be similarly treated for statement purposes. The income account of 1,000 certificates held throughout the year may then be prepared in the following form:

Value of 1,000 certificates at beginning	$100,000.00	100.00%
Income per 1,000 certificates:		
Profit on sale and interest	$2,294.56	2.29%
Less: Management expense	1,069.11	1.07%
Income subject to normal tax	$1,225.45	1.22%
Capital gain	....	......
Dividends	1,050.00	1.05%
Non-taxable income	425.66	.43%
Total realized income	$2,701.11	2.70%

Unrealized market appreciation....	$4,210.53	$4.21%
Gross increase in value of 1,000 certificates..................	$6,911.64	6.91%
Less: Distributions...............	....	......
Net increase in value of 1,000 certificates.......................	$6,911.64	6.91%
Value of 1,000 certificates at end of period..........................	$106,911.64	106.91%

For the first year, percentages may be omitted, since the amounts give the same information in greater detail. In subsequent years, percentages will show appreciation during the year, whereas the amounts will continue to express the rate of increase on the par value of the certificates. The subdivision of this income account into quarterly or even monthly figures is essential, whenever the annual rate of earnings per certificate during the several months varied substantially from its average for the year.

The simplest form of the report furnished to the certificate holder for filing with his income-tax return is undoubtedly a carbon copy of his page in the certificate ledger. The total income or loss reported must agree with the net increase or decrease as shown by the comparative balance-sheet furnished at the same time. The certificate ledger best adapted for this purpose will consist of an alphabetical tray containing the individual accounts in original and duplicate. At the annual closing or upon redemption, the duplicate is detached and mailed, whereas the original is filed in an inactive binder.

Exhibit A

THE UNINCORPORATED

Combined cash book,

Cash — Certificates	Cash — General	Call loans	Accrued interest	Dividends declared	Securities owned	Folio	Description
							Sept. 1
							A. White
							F. Brown
$1,000,000.00							J. Black
					$886,500.00	1	6,000 U. S. Steel
	$977,750.00				91,250.00	2	1,000 North American
	55.62						Sept. 30
							Oct. 3
	153,250.00				*147,750.00*	1	1,000 U. S. Steel
	150,000.00	$150,000.00					New York Trust Co.
	59.80	1,050.00					Oct. 31
							Nov. 3
			$ 6.40				Interest bank balance
			112.50				Interest call loan
				$10,500.00			6,000 U. S. Steel
							Market apprec. $100,000
							Management fee
$1,000,000.00	*$ 974,384.58*	$151,050.00	$ 118.90	$10,500.00	$830,000.00		
							Nov. 4
							H. Greene 500 sh.
111,612.31							F. Greene 500 "
	161,300.00				*147,750.00*	1	1,000 U. S. Steel
	250,000.00	250,000.00					New York Trust Co.
	111.07	1,775.00	*118.90*				Nov. 30
							Dec. 8
			31.64				Interest on bank balance
			800.00				Interest on call loan
							Market apprec. $50,000
							Management fee
	10,000.00						Management fee paid
$1,111,612.31	*$1,072,973.51*	$402,825.00	$831.64	$10,500.00	$682,250.00		
							Dec. 9
107,575.30							F. Brown 1,000 sh.
53,787.65							H. Greene 500 "
	152,825.00	*152,825.00*					New York Trust Co.
	11,331.64		*831.64*	*$10,500.00*			Dec. 31
					250.00	2	25 Stock Div. North Am.
	2,325.00				*250.00*	2	" " " "
			57.11				Interest bank balance
			1,250.00				Interest call loan
							Market apprec. $40,000
							Management fee
$ 950,249.36	*$ 906,491.87*	$250,000.00	$1,307.11		$682,250.00		
950,249.36	950,249.36						Closing entry
	$ 43,757.49	$250,000.00	$1,307.11		$682,250.00		

INVESTMENT TRUST

journal and general ledger

Folio	Certificates outstanding	Surplus	Profit on sale Interest	Capital gain on sale	Dividends	Non-taxable income	Management compensation	
							Expense	Liability
1	$ 500,000.00							
2	100,000.00							
3	400,000.00							
			$ 55.62					
			5,500.00					
			1,109.80					
			6.40					
			112.50					
					$10,500.00			
							$11,062.22	$11,062.22
	$1,000,000.00		$ 6,784.32		$10,500.00		$11,062.22	$11,062.22
4	50,000.00		339.21		525.00	$ 5,000.00	58.06	
5	50,000.00		339.22		525.00	5,000.00	58.06	
			13,550.00					
			1,767.17					
			31.64					
			800.00					
							654.94	654.94
								10,000.00
	$1,100,000.00		$23,611.56		$11,550.00	$10,000.00	$11,833.28	$ 1,717.16
2	100,000.00		2,146.51		1,050.00	5,454.54	1,075.75	
4	50,000.00		1,073.25		525.00	2,727.27	537.87	
						250.00		
			99.39			1,975.61		
			57.11					
			1,250.00					
							63.06	63.06
	$ 950,000.00		$21,798.30		$ 9,975.00	$ 4,043.80	$10,156.60	$ 1,654.10
1–5		$25,660.50	21,798.30		9,975.00	4,043.80	10,156.60	
	$ 950,000.00	$25,660.50						$ 1,654.10

Exhibit B

THE UNINCORPORATED INVESTMENT TRUST

Certificate Ledger

Date	Description	Folio	Certificates outstanding	Surplus	Profit on sale Interest	Capital gain on sale	Dividends	Non-taxable income	Management expense
				A. WHITE					
Sept. 1	Original issue 5,000	1	$500,000.00						
Dec. 31	Closing entry	1		$13,505.53	$11,472.79		$ 5,250.00	$2,128.32	$ 5,345.58
Dec. 31	Income (*Loss*) reported				$11,472.79		$ 5,250.00	$2,128.32	$ 5,345.58
				F. BROWN					
Sept. 1	Original issue 1,000	1	$100,000.00						
Dec. 9	Redeemed 1,000	1	100,000.00		$ 2,146.51		$ 1,050.00	$5,454.54	$ 1,075.75
	Transfer				5,454.54			5,454.54	
Dec. 31	Income (*Loss*) reported				$ 7,601.05		$ 1,050.00		$ 1,075.75
				D. BLACK					
Sept. 1	Original issue 4,000	1	$400,000.00						
Dec. 31	Closing entry	1		$10,804.42	$ 9,178.23		$ 4,200.00	$1,702.65	$ 4,276.46
Dec. 31	Income (*Loss*) reported				$ 9,178.23		$ 4,200.00	$1,702.65	$ 4,276.46
				H. GREENE					
Nov. 4	Issued 500	1	$ 50,000.00		$ 339.21		$ 525.00	$5,000.00	$ 58.06
Dec. 9	Redeemed 500	1	50,000.00		1,073.25		525.00	2,727.27	537.87
Dec. 31	Transfer				2,272.73			2,272.73	
Dec. 31	Income (*Loss*) reported				$ 1,538.69				$ 479.81
				F. GREENE					
Nov. 4	Issued 500	1	$ 50,000.00		$ 339.22		$ 525.00	$5,000.00	$ 58.06
Dec. 31	Closing entry			$ 1,350.55	1,147.28		$ 525.00	212.83	534.56
Dec. 31	Income (*Loss*) reported				$ 808.06			$4,787.17	$ 476.50
				TRIAL BALANCE					
Dec. 31	A. White 5,000	1	$500,000.00	$13,505.53	$11,472.79		$ 5,250.00	$2,128.32	$ 5,345.58
	F. Brown	2			7,601.05		1,050.00		1,075.75
	D. Black 4,000	3	400,000.00	10,804.42	9,178.23		4,200.00	1,702.65	4,276.46
	H. Greene	4			1,538.69				479.81
	F. Greene 500	5	50,000.00	1,350.55	808.06			4,787.17	476.50
			$950,000.00	$25,660.50					
			950,249.36	25,411.14	$27,521.44		$10,500.00	$ 956.20	$11,654.10
			$ 249.36	$ 249.36					

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 AUDITING

November 13, 1930, 9 A. M. to 12:30 P. M.

No. 1 (10 points):

Under which, if any, of the following conditions would you permit interest to be considered a part of manufacturing cost and of inventory valuation? State the general governing principle. Give reasons.

(a) A manufacturing company in leasing its premises in lieu of a fixed rental pays the lessor a stipulated rate of interest upon his investment in the premises plus a royalty upon the quantity of products manufactured.

(b) A timber company, having held a tract of timber for a long period, has capitalized the interest upon the mortgage on the timber; and now, upon manufacturing the timber into lumber, proposes to write off depletion based on book values.

(c) A sugar plantation and factory, newly organized, has set up interest on money borrowed to raise its first sugar-cane crop as part of the cost of the crop during the two years required to raise it.

(d) A cocoanut-oil manufacturer buys copra in the Philippines, accepting in settlement an interest-bearing draft which is forwarded by the sellers to their bankers in San Francisco with bill of lading attached. The same copra could have been purchased f.o.b. San Francisco at a higher price.

Answer:

(a) The amount paid by the manufacturing company in lieu of a fixed rental should be charged to manufacturing expense to be applied to production during the period. Any inventory of merchandise produced and still on hand at the end of the period should include, as part of its cost, the pro rata share of such amounts paid in lieu of rent. The fact that the charge for occupancy of the leased premises is based upon "a stipulated rate of interest upon his investment in the premises plus a royalty upon the quantity of products manufactured" does not change the nature of the charge from one of rent, which is a manufacturing cost.

(b) Whether or not the interest upon the mortgage on the timber which was held for a long period of time by the company should be capitalized is largely a question of policy. If this particular tract of timber was the only one held by the company, there could be no question of the propriety of charging the interest paid on the mortgage as a part of the cost of such timber upon which depletion should be based. Otherwise, the company would find itself in the position of having incurred a profit and loss deficit before it began its operations —contrary to generally accepted accounting principles. If, on the other hand, the company held other tracts of timber, the same principle could be applied, inasmuch as each tract would, most likely, be treated as a separate unit of operation.

(c) On the same principle of accounting as outlined in (b) above, the interest paid on money borrowed to raise the first crop of sugar cane, may be capitalized by the newly organized company; otherwise, it would find itself with a profit-and-loss deficit before it had reached the stage of selling its product and receiving income thereon.

(d) The interest-bearing draft accepted in settlement for the purchase of copra made in the Philippines, is only a method of payment, and is not a part of the cost any more than would be the payment of interest on a sixty day interest-bearing note given at the time of a purchase made from a domestic seller.

No. 2 (10 points):

State how you would proceed in making a detailed audit of a bank.

Answer:

The auditor should obtain control of the cash and the securities and should keep the total thereof under control until accounted for in full. This may be accomplished by distributing the staff and making the various cash counts and security verifications simultaneously, or by placing the securities under seal while the cash is being counted. Representatives of the bank should be required to be in attendance with all members of the accountant's staff.

Since the cash will consist in part of cheques and other commercial paper to be deposited in other banks, the integrity of the cash balance depends upon the validity of these instruments. Hence, the auditor should determine whether any of the paper included in the cash count was later returned because of insufficient funds or for any other purposes.

Accounts with other banks (including the Federal Reserve Bank), the clearing house, and with state or other governmental agencies to protect trust funds, currency circulation, etc., should be verified by confirmations and reconciliation of the current accounts. If a complete detailed audit is required, and the number of depositors and bank loans is such that the cost would be prohibitive, it might be suggested that the procedure of securing confirmations from the depositors and customers, to whom loans had been made, be followed.

The collateral loans should be listed and the collateral examined, noting that such collateral has been endorsed or is accompanied by a proper power of attorney.

The securities representing the bank's own investments should be examined and listed or checked against lists furnished to the auditor. These lists, of course, should be checked against the balances in the securities accounts.

The cashier's cheques, letters of credit, certificates of deposit, etc., outstanding at the balance-sheet date should be verified by checking against the stubs, and/or duplicate records, and by tracing their subsequent disposition. Especial attention should be directed to any of these items which are marked cancelled.

The stub books should be examined to determine whether or not any drafts, cheques, etc., have been removed from the back of the books and used for possible fraudulent purposes.

Detailed trial balances of the demand deposits, savings deposits, loans and commercial paper, and general ledger should be prepared.

The other assets and liabilities, and the capital stock, surplus, and undivided profits accounts may be verified in the usual manner. The minutes of meetings of the board of directors, executive or other committees should be read to see if any action taken by them was reflected in the accounting records.

Income on securities owned should be checked against the securities held to learn if all such income has been entered. All postings to the general ledger should be checked. The amount of footing of the journals, checking of postings, vouching of disbursements and receipts will depend upon the system of internal check, the effectiveness of the bank's own auditing department, the number of transactions, and the desire of the client.

No. 3 (10 points):

One of the duties of an auditor is to ascertain whether or not any liabilities exist which are not shown on the books. What procedure would you follow?

Answer:

The auditor, to ascertain that all liabilities of the business are accounted for, should proceed somewhat as follows:

(1) Secure confirmations from the banks or other fiscal agents of any amounts owing for loans, mortgage or bonded debt, notes discounted, etc.

(2) Request all creditors, to whom notes were issued during the year, to send a list of any notes (giving date, maturity, interest rate, names of makers and / or endorsers, and amount) held by them at the balance-sheet date.

(3) Study the minute book of the corporation to learn of any liabilities not recorded, and secure confirmations.

(4) If the client objects to the mailing of requests for confirmations to all of the trade creditors, the regular monthly statements received by the client from such creditors should be compared with the balances shown in the auditor's list of such creditors. Any differences between the balances shown by the statements and those shown in the auditor's list should be accounted for.

(5) Payments made subsequently to the date of the balance-sheet should be analyzed (if a satisfactory voucher system is not in operation) to learn whether any such payments were made on invoices applicable to the prior period.

(6) The unpaid invoice file should be examined to ascertain whether any applying to the previous period had not been entered.

(7) Accrued liabilities, such as accrued salaries, wages, commissions, taxes, legal expense, interest, etc., can readily be verified. The expenses applying to previous month and payable the following one, such as telephone, telegraph, light, power, etc., must also be recorded in order to charge the period which received the benefit therefrom. The auditor should compare the kinds and amounts of the accrued liabilities set up at the balance-sheet date, with those shown at the end of the previous period.

(8) A certificate should be obtained from the proper officer or partner stating that all liabilities, for the period or for any previous period, have been recorded in the accounts, and setting forth any contingent liabilities of the company not entered.

No. 4 (10 points):

In auditing the accounts of a corporation for the first year of its existence what records and documents should be examined before starting on the regular books of account? State reason for each step.

Answer:

In auditing the accounts of a corporation for the first year of its existence, the auditor should examine the minute book and charter of the company.

From the charter he should learn, among other things, the date of incorporation, the purpose of the company, and the authorized capital stock by classes. The auditor should examine the capital stock accounts in the general ledger to learn whether such accounts appear in accordance with the authority granted by the state in the charter issued to the company.

He should expect to find in the minute book such information as the names and addresses of the subscribers with the amounts of the different classes of stock subscribed, method of payment of subscriptions (if in property, the kind and value of the same), the names of the directors and officers of the company, authority to purchase plants, equipment, other corporations or businesses, commitments for future deliveries of goods, declarations of dividends, payments of bonuses, settlements of litigation, reserve appropriations, setting forth of appraisals, etc. If authority is delegated to an executive and/or finance and/or any other managerial committee, the auditor should examine the minutes of the meetings of such committees. The purpose of the examination of these records is to learn whether the actions of the directors, etc., have been expressed in the accounting records, and to ascertain the authority for transactions of unusual nature or of major proportions.

No. 5 (10 points):

The following certificate was appended to the consolidated balance-sheet of the Blank Corporation and its subsidiaries:

We have examined the books and accounts of the Blank Corporation and its domestic and South American subsidiaries and affiliated companies for the year ended December 31, 1929, and have had submitted to us the audited statements of the remaining foreign subsidiary companies. The assets and liabilities of subsidiary companies other than the South American companies are embodied in the above balance-sheet. South American and affiliated companies are treated as investments. In accordance with the decision of the directors, no charge for depreciation of plants was made during the year. We certify that upon the foregoing basis the balance-sheet is in our opinion correctly prepared so as fairly to set forth the financial position of the companies at December 31, 1929.

What qualifications are there in the above certificate?

Answer:

The qualifications in the certificate appended to the consolidated balance-sheet of the Blank Corporation and its subsidiaries are:

(1) The books of certain foreign subsidiary companies were not audited by the certifying auditor who used in the consolidated balance-sheet, such amounts of assets and liabilities as were shown in the reports furnished by other auditors.

(2) The assets and liabilities of the South American subsidiary companies were not included as such in the consolidated balance-sheet. The investments in such companies were shown as investments. No reason appears to explain why an exception was made in not consolidating the assets and liabilities of these particular companies.

(3) Depreciation was not provided for during the year under review, resulting in an understatement of the surplus account as shown in the balance-sheet.

No. 6 (10 points):

The Y Corporation on December 31, 1929, shows the following balances in its accounts with banks:

First National	Debit balance	$20,000
Second National	Overdraft	5,000
Fifth National	Debit balance	10,000
Total agreeing with cash account		$25,000

State how you would show these balances on your balance-sheet and explain why.

In what circumstances would you modify your decision?

Answer:

As the balances given in the question are book balances and do not consider any outstanding cheques drawn, but not paid by the banks, the actual balance at the Second National Bank may not show as an overdraft. In any event, a cheque drawn on either of the other banks could be deposited with the Second National Bank to make good the overdraft. Because of these possibilities, it is generally considered proper to show the net amount of the cash in banks as an asset of a going business.

Cash in banks:		
First National Bank	$20,000	
Fifth National Bank	10,000	
Total	$30,000	
Less—Overdraft Second National Bank	5,000	$25,000

If the company was not a going business, or if the amount of the overdraft was in excess of the free balances in the other banks, the overdraft should be shown as a current liability, and the debit balances in the other banks should appear as assets. It should be noted, however, that some authorities make no exception to the treatment of overdrafts as current liabilities.

No. 7 (10 points):

The X Corporation was organized in 1914 with a capital stock of $10,000, paid in cash, and all owned by John Doe, unmarried and without dependents. By 1925 it had accumulated a surplus of $50,000. The capital stock was then increased to $50,000, and a stock dividend of $40,000 was declared and paid to John Doe. During the next four years the average profit from the business, after deducting a salary of $10,000 a year to John Doe as president and general manager, was $2,500 a year, so that on December 31, 1929, the net assets of the corporation were $70,000, represented by $50,000 capital stock and $20,000 surplus, all of both being invested in plant and equipment.

In addition to the federal income tax, the corporation pays a state property tax of ½% on the book value of its capital stock; and John Doe, of course, pays a federal normal tax and surtax on his salary plus other income.

In 1930, exasperated by the increasing taxes and the annual state and federal reports he must make on behalf of the corporation, John Doe consults his lawyer who advises him to liquidate the corporation by turning in his stock in exchange for the net assets, to surrender its charter, and thereafter to conduct business individually.

You are engaged to supervise the accounting details of the proposed reorganization, and your opinion of the lawyer's suggestion is asked.
What would you advise, and why?

Answer:

If the corporation is liquidated during 1930, and the net assets are turned over to John Doe, the sole stockholder, for his capital stock in the company, Mr. Doe will receive taxable income represented by the excess of the "actual" value of the assets at the time received over the cost of his stock. The courts have held that "upon the dissolution of a corporation and the transfer of its assets to the sole stockholder who continues the business, the sole stockholder is subject to both normal tax and surtax upon the difference between the cost (or other basis) of the stock and the amount received in liquidation."

The amount of the net assets which John Doe will receive from the corporation (considered as the "actual" value at the time of the liquidation) is	$70,000
The amount paid in cash by him for the entire outstanding stock of the company was	10,000
The taxable income resulting from the transaction would be the difference, or	$60,000
The tax on this income under the provisions of the capital net gain section would be, 12½% of $60,000 or	$ 7,500

In addition, Mr. Doe would be subject to tax on the salary paid to him by the corporation during the year 1930, upon the profits of the business operated as a sole proprietorship during the remainder of the same year, and upon any other income received by him during that same year. The amount of such tax can not be computed because all the necessary facts are not given in the problem.

The business, operated as a corporation, will be required to pay during the year 1930:

State property tax of ½% of $70,000 (the book value of the capital stock)		$350
Income tax to federal government:		
Taxable income	$2,500	
Statutory credit	3,000	
Remainder, subject to tax		0
Total for the year		$350

The salary of $10,000, paid to John Doe, is a deductible expense to the corporation, and therefore not taxable to it. While Mr. Doe is required to report it in his tax return as salary, he would, however, be required to report the entire income of the business (if operated as a sole proprietorship) before his salary and/or drawings were deducted, or $12,500. In other words, Mr. Doe's income from the business would be reported at $2,500 more than is now reported, resulting in an increase in the amount of tax payable, not only because of the increase in the amount of income received, but because the additional income would be subject to tax at higher rates. Mr. John Doe should be easily persuaded to continue to operate the business as a corporation, if the above points showing the savings in taxes were presented to him.

No. 8 (10 points):

You are auditing the accounts of a restaurant and find that the cost of food supplies is too high in proportion to the receipts from sales.

The restaurant is on the street level of an office building in a busy district of the city. There are four entrances to the restaurant, one on each of three different streets and one from the office building. There is a receiving cashier at each entrance, and cash registers are used. All meals are served at tables and bills are given to customers who make all payments to the cashiers. The kitchen is separated from the dining-room, and two doors are used for service both ways. As the restaurant is open 16 hours daily there are two shifts of employees.

The kitchen manager, who buys all food supplies, contends that the kitchen has issued more meals than have been accounted for in the receipts.

You are asked to suggest a method by which all food taken from the kitchen can be accounted for more exactly. The method suggested must not increase the expense, it must not affect the speed of service in rush hours, and the number of entrances must not be reduced.

What would you suggest?

Answer:

The question states that expense must not be increased nor the speed of the service affected by changes. This, therefore, precludes the thought of having checkers at the two entrances to the dining room to check and stamp the customers' bills. The following procedure could be adopted:

(1) Cause all bills to be prenumbered.
(2) Have the customer write out his own order on the bill before handing it to the waitress.
(3) Have the waitresses present the bill to the kitchen to obtain the food. Food consumed by employees should be entered on bills also, whether paid for or not.
(4) Account for all numbers either in paid bills or unused bills at the end of the day.

The method outlined would prevent, to a large extent, errors, intentional or otherwise, on the part of the waitresses when preparing the bills, and should account for all food served in sales, and as meals to employees.

No. 9 (10 points):

You are engaged to draw up a partnership agreement for a firm about to be organized. State at least ten important points to be covered in such an agreement.

Answer:

Ten important points to be covered in a partnership agreement are:

(1) The names of the partners.
(2) The name of the partnership.
(3) The date at which the partnership agreement is to take effect.
(4) The nature of the business to be conducted by the partnership.
(5) The location of the place of business.

(6) The amount to be invested by each partner, covering in detail the penalty for failure to meet the agreed upon contribution, and the adjustment for any overcontribution of the stipulated amount, such as interest thereon. If interest is chargeable upon drawings, or allowed on capital accounts, it should be stated, giving the rates, and the dates at which it is to be entered.

(7) The nature and division of the work and authority of the respective partners.

(8) The "profit and loss" sharing ratio of the respective partners, and the dates at which such profits are to be determined.

(9) The amount of drawings or salaries to the partners, and a clear statement to the effect that the drawings or salaries are, or are not, to be deducted from the profits before such profits are distributed to the partners.

(10) The expiration date of the agreement, if any. Provision should also be made as to the method to be followed in liquidating the partnership at its termination; if terminated upon the death of one of the partners, the agreement should set forth such points as the computation of the interest on capital accounts, and the method of determining good will, if any.

No. 10 (10 points):

In making a balance-sheet audit of the A B Corporation you have received a certificate, signed by the president and general manager, of inventory amounting to $60,000, which you have tested to your satisfaction as to prices and clerical accuracy. Later before the close of the audit you discover that the corporation has filed an income-tax return showing an inventory of $50,000. What will you do?

Answer:

The auditor is put on notice that the inventory valued at $60,000 by the company, should receive a more thorough verification than testing as to prices and clerical accuracy. Whether the discrepancy between the inventory used by him and that used for income tax purposes results from changes in prices and/or quantities should be learned, if possible. Inquiry should be made to ascertain whether a detailed inventory supporting the $50,000 valuation had been prepared; if such was the case, the auditor should obtain it for purposes of comparison with the detailed inventory of $60,000 furnished him.

A check of the recapitulation of both inventories should then be made to locate the section or sections in which the changes occurred; having determined the sections, the auditor should proceed with his analysis of the separate items. If the differences are changes in prices, these changes must be verified; if the differences are changes in quantities, the responsible person should be questioned and required to explain to the auditor's entire satisfaction. As a further precaution, the auditor should examine the records subsequent to the date of the balance-sheet, tracing a sufficient number of items to satisfy himself that the adjusted amounts are correct.

If no inventory supporting the value of $50,000 is on hand, the auditor should make rather extensive tests of the quantities stated in the detailed inventory. If by the nature of the business and the character of the inventory, such tests are impracticable, or unsatisfactory, his certificate must be qualified accordingly. If he is satisfied that the correct amount of the inventory should be $60,000, and that an inventory valuation of $50,000 was used in the income tax return, he should point out to the client, (1) that the books show the results of operations based upon an inventory of $60,000, (2) that an examining officer would readily see that the return filed was false, (3) that the company and officers signing the return would be subject to the penalties prescribed by law, and (4) that an amended return should be filed immediately.

Correspondence

RESTRICTIVE LEGISLATION

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: The letter from Mr. Berridge appearing in the March issue of THE JOURNAL OF ACCOUNTANCY is an illuminating contribution to this perplexing subject of restrictive legislation. It is there stated quite plainly that the proponents of restrictive legislation have one single object in view—their own personal or group protection. No reference is made to the usual perfunctory claim of protecting the interests of clients and the public, which indicates that it is recognized that this would not be effected by such legislation, notwithstanding the fact that the one reason for legislators to support such legislation is that the public is in some way benefited. Law-makers generally look with suspicion on the creation or confirmation of restricted occupations unless it can be clearly shown that it is required by a distinct public interest.

People are interested in the work of accountants in two ways, as investors or credit grantors who must rely on statements prepared by the accountants and as clients requiring accounting services. Restricting practice in a state to accountants of that state gives no real protection to investors or credit grantors. Their protection lies in the assurance that the men who sign the statements are qualified and reputable. Any restriction which tends to establish the qualifications and character of the men or firms—regardless of location—who sign financial statements should be supported by every right-thinking accountant. Beyond this, it seems difficult to go in protecting the public. In their capacity as clients, people presumably make a more careful inquiry into the qualifications and character of the accountants they employ than would be done by any state body. Moreover, accountants' organizations, both state and national, now work for the most part under recognized and published rules of ethics and have ethics or grievance committees to which anyone interested can apply. Restrictive legislation (except such as would establish the ability and reputation of whoever signs statements on which third parties must rely) gives no right or advantage to the public or business men which they do not already enjoy. A Pennsylvanian with businesses in four states is at liberty to employ four different local accountants or to have all the work done by his Pennsylvania accountant, whichever he prefers. To eliminate the latter alternative removes a protection, imposes an additional burden and creates an unnecessary impediment to business in general.

Mr. Berridge seems unduly pessimistic as to the future of the small firm. My own observation is that the small firm can well render many services which the large firm can not and that the few types of work which can be done only by a national organization are such that no small firm could successfully cooperate. Where better service can be rendered by a large firm, the large firm gets the work; in cases where the large firm is not qualified to render the service required by a client the small firm or individual practitioner is the one who produces satisfactory results.

Whether or not restrictive legislation in its most extreme form of geographical limitation is legally possible is not the important issue. The thing we must consider is whether that type of restrictive legislation benefits the public. If it does not it is inconceivable that in the long run it can benefit the profession.

Yours truly,

MAURICE E. PELOUBET.

New York, N. Y., March 11, 1931.

DEPRECIATION

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: The subject of depreciation is one on which countless writers have written, and upon which many discussions have taken place. It is with the thought of one of such discussions in mind that this letter is being written.

Practically all of the standard works state that depreciation should be based upon the theory that the cost of the article, less residual value, is the amount to be provided. This is good theory, but why must we confine our articles to theory? Is it that we are trying to banish the practical from our minds? I am unable to recall a single instance in which the theoretical plan has been followed. Invariably the asset account as such has been depreciated, irrespective of the estimated residual value, and it is my thought that for all practical purposes this plan may be followed.

If we are to practise in accordance with the theory mentioned above who is to establish the residual value? Having established such value, what accountant is capable of verifying such residual value unless it be a nominal amount? And why go to this trouble for a nominal amount?

Where a plant ledger is maintained, the practice could conceivably be followed, but alas, how few of our clients maintain a plant ledger, and how few are the annual converts to the use of one.

The subject of this letter is not the residual value of depreciable assets, so having disposed of this point I proceed to the subject in hand, which is the replacement of parts or the renewal of portions of the original asset.

In prior years the subject of replacements and renewals was not one which was very frequently encountered, as most of the clients were more or less conservative and charged such items to repairs or supplies; but with the advent of federal taxation on a major scale and the consequent examinations by field agents the subject has become one of vital importance. I have found that in some districts the agent in charge has instructed the field agent to investigate closely all supply and repair accounts with the intention of disallowing all such items which might be claimed to be replacements or renewals, charging such items against the reserves for depreciation.

The question now arises as to when and where the taxpayer is to obtain a deduction for such expenditures. No one will dispute the fact that expenditures for plant or equipment are deductions, not, it is true, in the year of the disbursement but periodically over the life of the asset. Now, with the treasury department allowing the deduction of depreciation to the extent of the original cost and then charging replacements and renewals against the reserve for depreciation, it can be seen that at the end of the estimated life of the asset we shall not have accumulated a reserve equal to the original cost, and yet we are not allowed to depreciate beyond the prearranged life period, which means that the taxpayer is not securing a deduction for amounts expended for replacements and renewals.

During the past few years I have followed the practice outlined below, and have had several tax returns audited and passed on such a basis. It might more properly be said that the returns were passed irrespective of the basis, as no question was raised with reference to it.

Accounts have been opened on the books for "replacements and renewals" and all such expenditures have been charged to those accounts. When preparing a balance-sheet the "reserves for depreciation" and the "replacements and renewals" are considered as being one account and are shown net on the balance-sheet as "reserves for depreciation." The replacement and renewals accounts are depreciated in the same manner and upon the same basis as the original asset account.

In my opinion, this procedure not only presents a correct accounting picture, but it also provides the taxpayer with a basis for securing a deduction for such expenditures during the period in which such replacements or renewals are being utilized.

Yours truly,

H. J. BEAIRSTO.

New York, N. Y., February 10, 1931.

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.]

VALUATION OF INVENTORIES

Question: We are preparing a balance-sheet as of March 1st, for one of our clients. Our report will be rendered about May 20th.

Inventories were valued at cost or (March 1st) market, whichever was lower. Between the date of the balance-sheet and the date of the submission of the report, there has been a decline in market prices of the raw materials in the inventory.

Questions:

(1) Should a reserve be provided for this decline in market prices, and if so, on what basis?

(2) If no reserve is set up, should a comment upon the decline in market prices be made in the certificate or report? or

(3) Should the decline in market prices be disregarded since it occurred after the date of the balance-sheet?

Answer: It is our opinion that the inventories, the subject of your inquiry, are properly valued in the balance-sheet at the lower of cost or market. At the same time, a reserve should be provided for the decline in market prices, the amount of such reserve being the difference between the inventory valuation and the value to which the market has declined. We are assuming a decline in prices stabilized within reasonably definite limits, since, if the downward price movement still continues, the stated reserve must be based on a consideration of the circumstances, and governed by a prudent conservatism. If, on the other hand, no reserve is made, appropriate comment should be offered in the certificate.

Answer: In reply to questions one and two, we believe that either a reserve should be set up or suitable comment made disclosing the fact of the decline of market prices and its effect on the financial position of the company. The answer to question three is, of course, that the decline in market prices should not be disregarded.

We believe, however, that the inquirer should consider other factors than those mentioned in your letter. It is quite conceivable that a substantial decline might have occurred between March 1st and May 20th without impairing the financial status as shown on the March 1st balance-sheet. That is, the entire inventory might have been liquidated before the decline in prices occurred. It is manifest that if such were the case any reference to the decline in market prices would give an unjustified impression as to the client's financial condition.

The measure of the reserve or of the qualifying comment should be the loss actually sustained and the potential loss still to be realized, in respect to the values shown as of March 1st. If the client had liquidated one half his inventory at a definite loss, such loss, together with the decline in value on the unliquidated portion, should represent the reserve requirement or amount to be embodied in the comments.

It is seldom possible to trace the liquidation of inventory satisfactorily so as to determine the exact loss incurred at a given date. It is not necessary to comment on the difficulties in establishing the actual and potential loss, but merely to state the principle which must be followed in order that no injustice be done to the client.

LEASE OF REAL ESTATE UNDER PARTNERSHIP

Question: A man who has a building on leased ground—the lease having a sixty-day notice-to-vacate clause—takes in a partner and the partnership makes an addition to the building which costs approximately $6,000.

The partnership is now being dissolved and the question arises: What portion of the cost of the addition should be paid by the partner (the original owner of the building before the extension was made) who is to occupy the premises in the future?

It should be pointed out that the building is on a main thoroughfare which is in the process of development and surrounding property is being built up and a notice to vacate may reasonably be expected at any time.

Answer: It is apparent that it is impossible to determine over what period the lessor of the land will have the benefit of the additions which cost $6,000, inasmuch as it is impossible to foresee the date when the lease will be terminated.

At the termination of the partnership, therefore, there can be no adjustment of the cost of the additional buildings which must be considered, at that time, as having no value. However, there should be an arrangement between the partners so that the partner who was the original owner of the building should pay to the other partner a fair proportion of the cost of the addition based upon the time during which the former continues to occupy the premises. In other words it would seem fair to pro-rate the $6,000 over the period of occupancy, which, at the time when the partnership was dissolved, was undeterminable but would be possible of determination in the future if the landlord took action under the sixty-day notice-to-vacate clause.

Answer: We do not see in the facts presented any definite basis for making an apportionment between partners. If notice to vacate is given and the building has to be vacated, presumably there will be a loss not only of a portion of the

$6,000 put in by the partnership but of the building previously owned by one of the partners. Considering the period during which the cost of the building and the cost of the addition should be charged against operations, you have the two extremes: one, that the total should be charged over a period of sixty days, and the other that the cost of the building and the addition should be spread over the reasonable life, taking into consideration the kind of construction. Probably a fair adjustment lies between these two extremes, but the facts given in the question offer no help in setting any exact or approximate period of life for either the building or the addition. In the circumstances we can only suggest that the two partners consider the question in the light of their own knowledge of the local situation and try to reach a friendly agreement based on a reasonable life, spreading the cost of the addition over the reasonable life from the time the addition was built up to the time when it will probably be discarded.

Answer: It might be possible to make an equitable settlement on the basis of ratio of the time during which the addition is used by the partnership to the total time from the date when the addition is completed to the date when it is necessary to vacate the building. Such an agreement, of course, would require that final settlement be made only after notice to vacate has been received, unless there is some other means of knowing when it will be necessary to vacate.

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Compiled in the Library of the American Institute of Accountants

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