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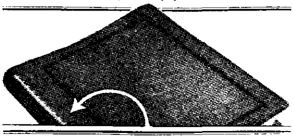

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VOL. 53 JANUARY, 1932 NO. 1

EDITORIAL

The Kylsant Conviction

In the court of criminal appeal, London, on November 4th, the appeal of Lord Kylsant was dismissed. Thus ended a case which attracted a great deal of attention in many parts of the civilized world, and it will doubtless go down in history as a leading case altogether apart from the prominence of the accused. Baron Kylsant was tried and convicted in the Central criminal court last July on charges which involved the publishing in 1928 of a false prospectus, for the purpose of floating an issue of debenture stock by the Royal Mail Steam Packet Company, of which he was chairman. The penalty imposed by the court is twelve months' imprisonment in what is known as the second division, in other words imprisonment without hard labor. This case has been the subject of comment in THE JOURNAL OF ACCOUNTANCY and practically every other accounting magazine throughout the world. But certain aspects of the case have not heretofore been discussed in these pages because it seemed improper to attempt such a discussion pending decision on the appeal. No one was able to foresee what the finding of the court of criminal appeal would be, and when the decision was rendered there was a good deal of sympathy for the defendant whose appeal had failed. Lord Kylsant had long been an eminent figure in the British commercial world. He was a distinguished man in every way—physically for his great height, socially for his recognized abilities, financially for his considerable wealth. It is always exceptionally distressing to find such a man near the close of his life thrust into prison because of misdeeds. There was a good deal of difference of opinion as to the extent of Lord Kylsant's guilt, and here in America where the matter is regarded in an altogether objective way, there were many people who professed astonishment at the hard, implacable march of judgment. Our withers are unwrung, and so we can be wholly academic and perhaps more inclined toward mercy than we would be if the offense committed had affected our own people. However, both here and in Great Britain there will be a natural leaning toward sympathy—that sympathy which is one of the blessed attributes of our modern civilization—with the aged prisoner at Wormwood Scrubbs.

A Strange Case Throughout

In this country there is no statute comparable to that under which Lord Kylsant's conviction was obtained; and indeed it is somewhat astonishing to find, as counsel for the defendant alleged, that the prosecution was based upon a statute seventy years old which had never before been invoked in exactly the same way. If there were such a statute in any of the American commonwealths it is difficult to believe that a criminal prosecution would have succeeded, because it must be borne in mind that there was a grave doubt as to the entire applicability of the statute. It will be remembered that the original charges against Lord Kylsant and Harold John Morland were dismissed in the court below and Mr. Morland was discharged. A supplementary count, which related solely to Lord Kylsant, was the basis of conviction. This concerned the issuance of a prospectus which, although true, was misleading, chiefly because it stated that the company had earned an average substantial profit over a period of ten years when as a matter of fact the earnings had accrued entirely in abnormal years at the close of the war. The company had operated actually at a loss during the latter portion of the decade covered by the statement. The statute which was invoked provides that fraud of the sort alleged must involve falsity in a material particular, and, in view of the fact that the prospectus in question was technically true, a good many legal authorities felt that conviction was of dubious validity. However, the conviction was upheld by the court of criminal appeal, and we have therefore a precedent of conviction for false statements which are literally true. Of course, it is obvious that a statement such as that contained in the prospectus is misleading. To what extent, however, the public would be misled is naturally a matter of opinion. Some people will be inclined to the belief that very few investors would be deceived, and others are equally confident that the deception would be wide-spread. Certainly a careful investor would not be greatly influenced by a statement of averages. Indeed it is permissible to go further and to say that there is no excuse for being deceived by such specious statements. A company whose earnings were satisfactory would not care to rely upon a statement of ten-year averages but would prefer to show the actual earnings of each year and thus to demonstrate the progress of the business. The very fact of resort to average is a red flag to the cautious. The only possible purpose of an average statement is to cover up a decline in earnings.

An Inconsistent Judgment

The conviction was based chiefly upon the alleged falseness involved in the statement of average. Some point was made during the trial of what might have been revealed had the earnings been allocated year by year, but while this would have given the prospective investor the information to which he was entitled it would not have affected the average, which was apparently quite truly presented. Indeed in his summing up Justice Wright, of the Central criminal court, said:

> "If . . . adjustments had been made putting into the earlier years all these matters which were afterwards brought into the later years . . . still the average would not have come out anything different or at all substantially different. That is, of course, obvious. If you take an average you may within the period over which the average is taken have very diverse figures and I should imagine—I do not know, but one feels—that if ever I venture on a prospectus in future I shall look very shyly indeed at any reference to averages."

Everyone who is interested in even the most remote way in the financial statements of companies is concerned with the manner of the presentation of facts, so that those facts shall be illuminating and shall not becloud the issue. It seemed, therefore, important that the courts called upon to decide in the case of *Rex* vs. *Kylsant* should render their opinion in no uncertain way. It is most disappointing to learn from the record now available that the court of criminal appeal for some reason not clearly manifest confirmed the conviction on a different issue. It almost seems as if the court had felt a doubt as to the propriety of a conviction based upon the falsity conveyed in a statement of fact but, feeling that justice demanded conviction, had confirmed the decision of the lower court on a collateral argument. When rendering judgment in the court of criminal appeal Justice Avory said, in part:

"In the opinion of this court there was ample evidence on which the jury could come to the conclusion that this prospectus was false in a material particular, in that it conveyed a false impression. The falsehood in this case consisted in putting before intending investors, as material on which they could exercise their judgment as to the position of the company, figures which apparently disclosed the existing position, but in fact hid it. In other words the prospectus implied that the company was in a sound financial position and that the prudent investor could safely invest in its debentures. This implication rises particularly from the statement that dividends had been regularly paid over a term of years, although times had been bad—a statement which was utterly misleading when the fact that they were paid, not out of current earnings, but out of funds which had been earned in the abnormal war period, is omitted."

This seems to indicate a somewhat different course of reasoning in confirming the sentence from the basis of the conviction rendered by the lower court. In a word, it seems that an important precedent as to the interpretation of true statements so arranged as to mislead is seriously weakened by confirmation upon a different ground. It is not the same thing to state average earnings and to declare dividends over a series of years out of earnings which may have accrued in one year of the series. It is not at all uncommon to find corporations reserving a sufficient amount of earnings to meet dividend requirements of lean years; and, while the practice is not altogether commendable, it is not necessarily fraudulent. It may be quite excusable if a frank statement of the time of earning accompanies the declaration of a dividend of earnings. It would have been more helpful if the issue in the Royal Mail case had not been confused as it was.

Traditional Mystery

During the course of the Kylsant trial great emphasis was laid on the necessity of maintaining secrecy so that competitive companies should not be assisted to more intelligent competition. That is an old argument and it is trite. There is, of course, a certain amount of detail of inner working which may with advantage be regarded confidentially, but there is a deal of nonsense in what during the war was called "hush, hush stuff." In these days there are few trade secrets which are not as widely bruited in the trade as any of Mrs. Grundy's most secret slanders. If a company really wants to know what another company is doing and how it is done the information can be obtained. But the theory of secrecy is, as an able article in *The 19th Century and After* said recently, a sort of fetish. It is used as an excuse for a great deal of bad practice. If the directors of a corporation wish to withhold information which the stockholders are entitled to have, it is the common practice to fall back upon the excuse of trade secrecy. This is true in Great Britain and America and everywhere else. As a matter of fact it is probably safe to say that in most cases there could be absolute frankness on every detail of a corporation's business without injuring in any way the corporation or its prospects. The public, moreover, is going to demand greater candor than ever before. It is to be hoped that in Great Britain, which is the home of tradition, the experience of the Kylsant case will be taken to heart and we shall hear less of the sanctity of business secrets and more of the facts.

Responsibility Can Not Be Evaded

Auditors have been known to say that they have been helpless because the form of statement rests with the directors. They have said, such auditors, that so long as the legal requirements are met it is impossible to insist upon anything further. In other words, such auditors claim that there is no moral duty higher than a legal duty. The New York stock exchange has taken an active interest in the question of corporate accounts and it seems to be the sentiment of the exchange that compliance with legal requirements is not necessarily enough. The modern, progressive, honest accountant pays very little attention to the legal requirements, except to assure himself that all technicalities have been met, but proceeds to work in the way that will produce the true results. The moral obligation is far greater than the legal. The Institute of Chartered Accountants of England has now an opportunity to effect some necessary reforms. For example, it might be well for the English Institute to make a public pronouncement of its intention to encourage in every reasonable way the adoption of modern methods and the frankest exposition of financial condition. No doubt many of the members of the Institute would be glad to agree to abide by such a promise; and, if all the members would agree to refrain from accepting appointments which might be offered because of refusal by other firms, the effect desired would be attained. It would be infinitely better to have the reforms instituted by the profession itself than required by legislation.

English Practice Faulty

Many leaders of the profession in England are aware of the weakness and faults of current practices and they will insist upon a change. Indeed, it seems quite certain that the demand for reformation will be great enough to assure progress. Financial men and accountants have a common interest in raising the standards of practice. In Great Britain practice has lagged behind the development of modern methods in business. Here in America the profession is new and it has had the advantage of growing with the growth of business procedure. In many ways American accountancy is indebted to the profession in Great Britain—but let us hear what an outstanding member of the English Institute, and of the American Institute also, says on this subject. The following is a quotation from a speech delivered by Sir Arthur Lowes Dickinson at the annual meeting of the American Institute of Accountants in Philadelphia last September. He said:

"It is quite clear, from the papers and the speeches that have been presented at this meeting that the advance in the standards of accountancy here has been extremely great in the eighteen years that have passed since I was in practice here, and even in the twelve years that have passed since I was last in this country. I do not hesitate to say—particularly in view of a recent case in England—that in some respects the profession here—which was necessarily from its start based on that in England—has progressed to higher standards than obtain in England at the present time.

"One reason for that, I think, is that England has been to a certain extent hampered by the fact that there have always been laws and principles on accountancy, whereas in this country you have been able to develop the profession with very little regard, or necessity of regard, for the law, owing to the fact that there has been no law. You have been able to go ahead and enunciate higher principles and maintain them without being brought up short by your client saying, 'But, that is perfectly legal; why can't we do it?'

"I think it was Mr. Baldwin" (who had read a paper at the meeting) "who said that the accounting standards have to be in advance of whatever legal standards are laid down. I think that is absolutely true. You can not wait until the laws are passed. You have to think what is the right thing to do and then do it, lead the way and the law will follow all the time. I think that is the right and the only way in which a profession can advance.

"It is for that reason I think that the profession over here has in some respects advanced further and faster than it has in England."

Regulation Is a Scape Goat

Speeches have recently been delivered and articles have been written attempting to attribute the present unsatisfactory condition of the railways and other public utilities to an excess of regulation. We have been told that if there were no anti-trust laws, no inter-state commerce laws, no regulatory bodies in states and no municipal attempts to interfere with the orderly course of business it would be possible for companies engaged in providing service to the public to carry on their activities with profit. Then, by a natural process of reasoning, it would seem possible to keep great numbers of men employed, and we should return to that peak of prosperity which is now receding in the distance behind us. There may be a great deal of truth in the statement that we are the victims of too much legislation and regulation, but it is sheer folly to lay the world-wide depression at the door of these conditions. Something far more important and widely influential is the cause of the hard times. Such conditions as regulation are merely contributory, not the original cause. Furthermore it must not be forgotten that the so-called excess of regulation is nothing new. We had it throughout the wild prosperity which ended in 1929. Railways and other common carriers and many of the other utility companies were subject to the same amount of supervision and restraint during the most prosperous years of their existence, and we heard very little in those times of the evil effects of regulation, although there was, of course, an occasional outburst of wrath at some detail of administration. Now, when half the world is endeavoring to find out what is the matter with all the world, the wise men are discovering a score of reasons for the existing state of affairs, and each discoverer is convinced that what he has found is the real treasury of woe. Probably if we had no regulation at all there would be abundance of argument to the effect that regulation would save us. When people are driven to extremes they are quick to look about and lay blame where really very little blame may attach. This seems to be the position in which we stand at present.

But Regulation Is Not Innocent

Nevertheless, it is true that in over-regulation may be found influences which will retard the return of prosperity. Perhaps the law of supply and demand would be sufficient regulation in these days. If railways attempted to raise their tariffs to a point injurious to trade they would not receive shipments of freight, and in a similar way passenger travel would be reduced if there were any attempt at extortion. As an illustration of this, it is interesting to note that some of the railways running to New York have recently adopted a plan providing passenger excursions at low rates. Despite expectations, the traffic on regular trains has not decreased, but there has been an enormous volume of traffic on the special trains—traffic which because of its magnitude is highly profitable. This seems to show that the public is ready to spend money on traveling if it can do so at a reasonable rate. All the regulation in the world can not be as effective as popular demand. The little differences of opinion on the subject of freight rates and the like seem tremendously important to those who are intimately concerned with them, but in the large they do not really have much bearing on the question at issue. The competition of commerce is the controlling factor. It has been said also that if there were no attempt to interfere with the combinations of trade such as those which were the butt of the Sherman law, business would be encouraged to develop; but here again it seems that too much stress is laid upon the effect of one piece of legislation. The Sherman law does not interfere greatly with reasonable agreements between companies, and if we were proceeding in a time of normal activity most business men would entirely forget the existence of such a law. It does not often interfere with the orderly course of business. However, these protests and complaints are being heard increasingly and it may be that congress will be prompted to do something about the claims for greater freedom of action. It all depends upon the amount and quality of the demand. As a rule congress is not totally deaf to the cries of the constituencies. If it should happen that out of the bewilderment of a congress assembled in a time of crisis there should come a breaking down of the restrictions imposed by legislation in the past, what a strange spectacle would be presented. We should see the legislative body of the country attempting to relieve distress by the abolition of walls which were set up to keep out distress. Almost all the regulatory laws with which we are afflicted had their genesis in the demand for protection against oppression. Now, when everyone is seeking a reason for our being where we are, we should be turning about face if we attacked and destroyed the measures which we did regard as safeguards. No one knows what congress in its wisdom may decide to do. Probably congress itself is equally in the dark; but it is to be hoped that when the time comes—as it will come—to enact measures of relief, it may be possible to bring about the desired results without rushing to the other extremity and destroying all protective means. The danger is, of course, that if we begin to throw away our notions of regulation we shall revert to something which will bear a close resemblance to commercial and industrial anarchy.

Accountant on Reorganization Committee

Accountants generally will be interested in an advertisement, which appeared in *The Times*, New York, November 24th, of a plan for the reorganization of the Southwest Dairy Products Company. The advertisement announces the appointment of a committee to carry out plans involving the company's outstanding gold debenture bonds and all classes of its outstanding capital stock. The fact of importance to accountants is that the first name on the committee is that of Arthur Andersen, who appears not as an auditor but as a member of the committee. It has long been contended by accountants and also by other persons who are familiar with practice abroad that, because of their general professional knowledge, accountants should be appointed as members of reorganization or protective committees; but unfortunately the attempt to bring about the adoption of this idea has been considerably retarded by the failure to recognize its desirability. Mr. Andersen's appointment is one that may be regarded as setting a precedent which it is hoped other groups of shareholders, when they find themselves compelled to appoint committees, will follow. Mr. Andersen is a member of the executive committee of the American Institute of Accountants and has had much experience in both the theory and practice of the profession.

Some Difficulties Arising in Consolidated Financial Statements*

By Walter A. Staub

The difficulties which arise in the preparation of consolidated financial statements, whether balance-sheet or income account, may be broadly grouped in two classes. One class consists of those difficulties which arise in the application to concrete cases of principles or concepts which have become recognized as fundamental to the preparation of financial statements for two or more corporate entities which constitute an economic or financial unit.

The second class of difficulties includes those which do not involve the application of a principle peculiar to consolidated statements. In such instances it is purely fortuitous that the difficulty has arisen in the course of preparing consolidated statements, and the same principles as apply in the case of single unaffiliated companies are to be followed.

It is the primary purpose of this paper to deal with some of the difficulties and problems falling in the first of the two classes mentioned.

It may not be amiss to mention that even in preparing unconsolidated statements the principles underlying consolidated statements should receive recognition so that misleading impressions or conclusions by the reader of the unconsolidated statements may be avoided. For example, in the case of a company which has one or more subsidiaries with or through which it does considerable business, it is important that the principle of excluding from the parent company's income account profits which have not yet been actually realized, because goods are still in the hands of the subsidiaries, be applied. Or again, if the dividends received from the subsidiaries during a fiscal year materially exceed the actual earnings of the subsidiaries during such period a disclosure should be made. Of course, if the dividends are out of profits accumulated by the subsidiaries prior to the acquisition of their stocks by the parent company, such dividends should not be included in the income account of the parent company at all;

*Address delivered at the annual meeting of the American Institute of Accountants, September 16, 1931, at Philadelphia, Pennsylvania.

they are merely a return of capital invested in the stocks of the subsidiaries.

It is surprising how the fact of a business enterprise embracing several separate corporate entities seems for some people to obscure fundamental principles. Let us assume a business carried on by a single corporation, which has a number of branches and that the branch managers participate in the profits and losses of their respective branches. No business man would for a moment question that before the balance-sheet and income account of this business can be considered complete—or correctly stated—the results of the operations of all the branches must be brought into the picture and that effect must be given to each branch manager's interest, first by setting aside from the profits the portion accruing to him, and secondly by charging against the combined profits that portion of the branch loss to be borne by any manager which it appears will not probably be collected from him.

Now, if in the situation above outlined various branches or departments of the enterprise happen to be separately incorporated and the interest of the managers is represented by the interest of minority stockholders in the subsidiaries, the principles underlying the preparation of complete and correct financial statements are absolutely the same. The results of each subsidiary's operations and its financial position, including especially its liabilities, must be included, and the effect of the minority interests must be considered, either in crediting them with that portion of the profits to which they are entitled or by charging into the consolidated income account those losses which the minority interests in theory should bear but in fact are likely to fall on the affiliated group.

This is all so elementary in principle that I almost feel that I should apologize for referring to it. Nevertheless, officers and directors of corporations have on more than one occasion set up statements which have been just as defective as though the operations and financial position of one or more branches had been omitted from the statements of a single corporation, or the effect of the branch managers' interests not recognized, and have endeavored to persuade the accountant that, because of the separate corporate entities involved, their procedure was justified. It cannot be emphasized too strongly, even at the risk of repeating the trite and obvious, that especially in this day of huge and complex business enterprises financial statements must disclose fact and substance and that subdivision of an enterprise into a number of separate corporate entities must not serve nor be availed of to conceal the true situation with respect to either financial position or operating results. Difficulties will frequently arise in the practical application to complex situations of principles which may be relatively simple in themselves. Here the accountant can make a vital contribution to the protection of the interests of creditors and shareholders of business enterprises by insisting on the application of sound principles, while aiding in the solution of the difficulties arising in the course of their practical application.

BASIS FOR CONSOLIDATING ACCOUNTS

One of the most difficult questions which constantly arises in practice is the determination of when companies not wholly owned should be included in a consolidated balance-sheet, or when they should be excluded. Almost every shade of opinion has been expressed on this point, varying from the suggestion that companies in which there is a bare voting control should be consolidated, up to the requirement of a large percentage of both voting control and financial interest. Apart from the question of what percentage of stock ownership would justify consolidation, the question has sometimes been raised as to the propriety of including in the consolidation a company in which a large stock ownership is held by the parent company but the stock is deposited under a voting trust running for a period of years. In theory, at least, this may prevent the parent company from exercising management control if the voting trustees do not choose to consider its wishes respecting the directorate of the subsidiary.

It seems clear that no arithmetical rule can be laid down requiring, for example, that all companies over a certain percentage of stock ownership shall be consolidated, and all others below the named percentage not consolidated. The circumstances of each case must be considered, and there are too many factors involved to permit a simple rule of this kind.

Among the factors which naturally call for consideration are percentage of stock ownership, class or classes of stock owned, voting control or absence thereof, management control, and economic or other relations to parent or other companies in the affiliated group. For example, the Western Union Telegraph Company includes in its consolidated balance-sheet properties held under perpetual leases and merged in the Western Union system, even though there is no stock ownership. The properties of companies held under term leases are not, however, included in the consolidated balance-sheet.

In speaking of percentage of ownership, one naturally thinks first of common stock ownership, but this question is not always as simple as it might at first seem. There may be another class of stock which, while not termed "common," is in much the same class, except that it may not have voting rights, or its voting rights may be much smaller proportionately than those of the common stock. There may be participating preferred stock which shares in the earnings of the subsidiary after such participating preferred and the common have each received a stipulated rate or amount per share.

The voting control of Company A may be lodged in a small percentage of its total outstanding capital stock. For example, assume that the voting control rests in stock representing, say, 25 per cent. of the total capital stock, and the other 75 per cent. is in shares having the same rights as to distribution of profits, distributions in voluntary or involuntary liquidation, etc. Company B, which owns the majority of the voting stock, may have only, say, 13 per cent. of the total capital stock of the company. It might lead to distortion of the financial picture to prepare a consolidated balance-sheet and consolidated income account for the two companies.

The factors of management control and intercompany economic relations, where there is less than 50 per cent. stock ownership, might not ordinarily be thought of as sufficient to warrant consolidation. Yet, they should receive consideration because the intercompany relations may be such that the company owning a minority of the stock and having the management control may, for the sake of its own business, have to finance operating losses of such an affiliated company.

Because the circumstances of each case may have so large a part in determining whether or not a given company should be included in a consolidated balance-sheet, there has been little effort made to state an arithmetical rule. It is of interest to note, however, that there are at least two large companies, whose stock is listed on the New York stock exchange, which have given expression to an arithmetical measure for their own use, and it is further of interest to note that both of them have set the figure at

75 per cent. The Anaconda Copper Mining Company and the North American Company have both indicated in their annual reports that companies in which they have a stock ownership of 75 per cent. or more will be consolidated, but not companies in which the ownership is less than that percentage.

The North American Company in its report to stockholders states its policy as follows:

". . . your company . . . classes as subsidiaries only companies in which it or its subsidiaries own voting control and at least 75 per cent. of the common stock and does not include in its consolidated income statements undistributed earnings applicable to substantial investments in other large public utility companies."

It is interesting to note the following definition of the term "subsidiary company," which appears in the English companies act (1929):

(1) Where the assets of a company consist in whole or in part of shares in another company, whether held directly or through a nominee and whether that other company is a company within the meaning of this act or not, and

(a) the amount of the shares so held is at the time when the accounts of the holding company are made up more than 50 per cent. of the issued share capital of that other company or such as to entitle the company to more than 50 per cent. of the voting power in that company; or

(b) the company has power (not being power vested in it by virtue only of the provisions of a debenture trust deed or by virtue of shares issued to it for the purpose in pursuance of those provisions) directly or indirectly to appoint the majority of the directors of that other company,

that other company shall be deemed to be a subsidiary company within the meaning of this act, and the expression "subsidiary company" in this act means a company in the case of which the conditions of this section are satisfied.

It is to be noted, however, that this definition was not formulated for the purpose of setting a standard for the preparation of consolidated balance-sheets, but for the application of those provisions of the act which call for the segregation of investments in and acounts receivable from and payable to subsidiary companies in balance-sheets of the parent company and for an explanation of the manner in which the earnings of subsidiaries have been treated in stating the income of the parent company.

The foregoing definition of a subsidiary is also of interest in considering the suggestion contained in the helpful address at last year's meeting of the Institute by J. M. B. Hoxsey, executive assistant to the stock-list committee of the New York stock exchange, that consolidated accounts might "attain their maximum usefulness to the stockholder by preparing consolidated accounts including all corporations in which directly or indirectly there is a holding of a majority of the voting stock." In an address which Mr. Hoxsey delivered before the New York State Society of Certified Public Accountants in April of this year, he referred to the above suggestion and elaborated it as follows:

"Among other things which I touched on in Colorado Springs was the subject of consolidated accounts. I voiced there the thought that there should enter into the consolidation all subsidiary companies, more than fifty per cent. of whose equity * stock was held by the holding company. As a result of that meeting there was appointed a committee of the American Institute of Accountants on coöperation with stock exchanges.

"Generally speaking, I believe that committee is in agreement with most of the things advanced in the paper but upon that particular matter they were adamant in refusing to agree. Personally of course I know that they are all wrong, but however that may be, what the stock exchange is trying to do is to get a consensus of opinion as to what are proper accounting methods and practices, and if we can not convince a committee of the most eminent accountants in the country that our position has been right on that then there is nothing to do but to cease butting our heads against a stone wall and change our requirements, and therefore since we have learned the views of these accountants on that we have changed the requirements of the listing committee and no longer require the same degree of consolidation as we have done heretofore, but are satisfied if the effect of the undistributed earnings of unconsolidated subsidiaries is shown upon the report submitted, either as an element in the consolidated income account as a separate item, with of course appropriate valuation of the assets thereby affected in the consolidated balance-sheet, or if not there, at least in a footnote.

"We do still insist however that the net result at least of operation of the system as a whole should be made fully known to the stockholders and we found no accountant who disagreed with that view."

The June 2, 1930, edition of the New York stock exchange requirements for listing applications called for an agreement on the part of the applicant corporation to furnish its stockholders annually with its own balance-sheet and income and surplus

* In Mr. Hoxsey's Colorado Springs paper he referred to voting stock.

statements for the last fiscal year, and similar statements for each corporation in which it held directly or indirectly a majority of the *voting* stock. The applicant company would be permitted, in lieu thereof, to furnish either (a) a similar set of statements fully consolidated for the group of affiliated companies: or (b) a similar set of statements consolidated as to the applicant company and specifically named or described subsidiaries, with separate statements for each unconsolidated corporation in which a majority of the voting stock was directly or indirectly held.

In a recent revision of the listing requirements, the above basis was changed from the holding of a majority of *voting* stock to a majority of *equity* stock, and it is further provided that if the consolidated statements exclude any company, the majority of whose equity stock is owned, the following requirements must be met:

(a) the caption of the statements must indicate the degree of consolidation;
(b) the income account must reflect, either in a footnote or otherwise, the parent company's proportion of the sum of or difference between current earnings or losses and the dividends of such unconsolidated subsidiaries for the period of report; and
(c) the balance-sheet must reflect, in a footnote or otherwise, the extent to which the equity of the parent company in such subsidiaries has been increased or diminished since the date of acquisition, as a result of profits, losses and distributions.

The applicant company must also agree that "appropriate reserves, in accordance with good accounting practice, will be made against profits arising out of all transactions with unconsolidated subsidiaries, in either parent company statements or consolidated statements."

The change from the use of voting stock to equity stock, as the basis for the definition of subsidiaries, is important. Equity stock, as I understand the exchange's definition of it, would include not merely common stock having voting power, but would also include any other class of stock which is on substantially the same basis as common stock, even though it does not have voting power or has it only in certain circumstances, such as the passing of dividends. In such cases the exchange would consider both classes of stock as equity stock and, it would seem to me, properly so. There is an interesting question as to whether or not participating preferred stock should be considered as equity stock. The provisions of participating preferred stock vary so much that it is quite possible that some issues could properly be classed as equity stock, while other issues would be excluded from that class. It would appear that the purpose of this change is to require not merely voting control but also a majority of the investment which is entitled to the earnings after all prior charges, including preferred dividends, are met.

The following is suggested as a general rule, so far as one can be stated, for the inclusion of subsidiaries in consolidated statements:

Companies in which 75 per cent. or more of the equity stock is owned by the parent company should ordinarily be consolidated;

Companies in which between 50 per cent. and 75 per cent. of the equity stock is owned, may be consolidated, depending on the circumstances of the particular case;

Companies in which 50 per cent. or less of the equity stock is owned should be consolidated only in unusual cases. Consolidation of companies in the last mentioned class must rest on the peculiar circumstances of each case and should be resorted to only for obviously strong reasons.

EXCLUSION OF A WHOLLY-OWNED SUBSIDIARY

The question has been raised whether there are any circumstances in which it is proper to exclude one or more of the wholly-owned subsidiaries from consolidated statements. As a general rule, if a consolidated balance-sheet is prepared at all, every wholly-owned company should be included. The United States treasury has consistently held to this principle with respect to consolidated income-tax returns and has insisted ever since 1922 (when the option given affiliated companies of filing either consolidated or separate returns was first incorporated in the revenue acts) that the option must be exercised "all or none" (excepting as to foreign subsidiaries and certain other exceptions named in the law). In other words, partial consolidation is not permitted. This seems reasonable with respect to tax returns.

In the case of financial statements submitted to stockholders or used for credit purposes, an argument is sometimes made for excluding a wholly-owned subsidiary from the consolidated statement, where the nature of its business is such that it is informing to show it separately. For example, General Motors Corporation excludes from its published consolidated balance-sheet the General Motors Acceptance Corporation, its wholly owned finance subsidiary. Since the beginning of 1929 the earnings of that subsidiary are included in the consolidated income account. The business of the General Motors Acceptance Corporation is of a financing or banking nature, while that of the General Motors Corporation and its subsidiaries generally is of an industrial character. It is to be noted that the General Motors Corporation includes in its annual report a separate balance-sheet of its Acceptance Corporation.

In the case of another company of substantial size, whose stock is listed on the New York stock exchange, which publishes a consolidated balance-sheet, a wholly-owned company in an apparently related business is not consolidated and in the text of the company's annual report the statement is made that the investment in the unconsolidated subsidiary has a value double that at which it is carried in the balance-sheet. No reason is given for not consolidating this wholly-owned subsidiary, nor is any indication given of what the earnings of this unconsolidated subsidiary have been.

Some corporations, as a matter of regular practice, do not combine the accounts of their foreign subsidiaries in consolidated statements. There would seem to be no particular objection to this practice if (1) due notice thereof is given in the statement, (2) if the foreign subsidiaries have not sustained losses, and (3) if no unrealized intercompany profit is included in the otherwise consolidated statements.

The danger of excluding any subsidiaries from the consolidated statements is well brought out by a recent occurrence which attracted much attention in the financial world. The stock of a company doing a world-wide business was actively traded in on the New York stock exchange and the annual report to the stockholders included a consolidated balance-sheet and consolidated income account. No accountant's certificate appeared on the financial statements. In the bankers' prospectus offering a large issue of the company's debentures to the public appeared a statement by the chairman of the company's board of directors that the earnings of the company for recent years as stated in the prospectus were substantially less than those previously published in the company's reports to its stockholders, and that the differences arose chiefly from the fact that the earnings previously reported were not fully consolidated and included profits on goods billed to certain subsidiaries before such goods had been sold by the subsidiaries.

Whenever special circumstances appear to justify the exclusion of a wholly or largely owned subsidiary from the consolidated statements of an affiliated group, a vital requirement is "disclosure," and a separate balance-sheet for the unconsolidated subsidiary or subsidiaries (and income account, if their income is not included in the consolidated income account) would usually meet this requirement.

It is of especial importance that no unprofitable subsidiaries (whether wholly or partly owned) be excluded from the consolidated statements without provision for their losses or adequate disclosure of the facts.

RESTRICTION ON DISTRIBUTION OF SUBSIDIARY EARNINGS

A matter which has had some discussion, particularly in relation to the consolidated income account, and also the consolidated surplus on the balance-sheet, has been whether or not any restriction which might interfere with the paying over of subsidiary earnings to the parent company must be considered in stating the consolidated income. Earnings of the subsidiaries must find their way, through the road of dividends or interest, into the treasury of the parent company in order to be available for meeting the dividends or interest on the latter's securities. Among the restrictions which may retard or limit the flow of income from the subsidiaries to the parent company are:

(a) Deficit on the books of a subsidiary at the date of its acquisition; the laws of most states would require that income subsequently earned by that subsidiary be retained to wipe out its deficit and only after that had been accomplished would its earnings be available for dividends to the parent company;

(b) Requirements for the subsidiary to retire bonds or preferred stock through a sinking fund appropriated from income, where by the terms of the legal instrument no part of the sinking fund appropriation shall be available for dividends on the common stock so long as any of the securities subject to redemption through the sinking fund shall be outstanding;

(c) The declaration of stock dividends by the subsidiary, thus making the earnings of the subsidiary, to the extent that they are transferred to its capital-stock account by reason of the stock dividend, unavailable for cash dividends;

(d) The financing of plant extensions by a subsidiary through application thereto of its profits, thus leaving it without the cash required to pay over its earnings to the parent company.

In general it may be pointed out that these restrictions would apply just as effectively in the case of a single company as in an affiliated group and still would not be deemed to prevent the inclusion of the company's full earnings in its stated income account. From a practical standpoint, restriction (a) could be readily disposed of through a reduction of the par or stated value of the stock of the subsidiary or through other form of reorganization. This would be an intercompany transaction which would have no effect on the consolidated balance-sheet and at the same time would meet the legal point with respect to the inability to pay dividends during the existence of a deficit.

Item (b) would call for segregation of the consolidated surplus to the same extent as the required segregation of the subsidiary surplus pursuant to the sinking-fund requirement. Such segregation, however, would be of the surplus, would be made after showing the consolidated income for the year and would be merely an appropriation thereof to a special surplus account instead of transferring the entire amount of the year's net income to the general or unrestricted surplus.

An intercompany stock dividend, item (c), effects no real change in the consolidated surplus. In dealing with the accounts of the several companies separately, the parent company would be warranted in crediting its income account with the same amount for the stock dividend received as the subsidiary company charges to its surplus account for the payment thereof. In consolidated statements such transactions are eliminated and produce no effect on the consolidated net income. The payment of a stock dividend by the subsidiary is not different in principle from utilizing cash realized from consolidated earnings to purchase stock of a new subsidiary or additional stock of an existing subsidiary.

With respect to item (d) the same observation may be made in the case of an affiliated group as in the case of a single company. Even though a considerable portion of the year's earnings may be reinvested in plant additions, the income is nevertheless stated at the full amount of the earnings, even though such investment in plant makes a portion of the income unavailable for cash dividends.

SURPLUS OF SUBSIDIARIES AT DATE OF ACQUISITION

While the principle of eliminating the surplus of subsidiaries at dates of acquisition is clearly recognized by the accountant, it is apparently not always readily recognized by business and financial interests. Where the parent company issues its own stock to acquire the stock of a subsidiary and the stated or par value of the parent company's stock is less than its fair market value, there may be a proper credit to capital surplus in the consolidated balance-sheet, representing the difference between the par or stated value of the parent company's stock and the value of the subsidiary's assets. Part of this difference may be represented by the surplus of the subsidiary at acquisition, as in cases where stock is exchanged par for par. However, the surplus so resulting is in fact capital surplus and must be shown separately and not merged with the consolidated earned surplus.

There have been cases where the pre-acquisition surpluses of subsidiaries have been carried forward into the consolidated balance-sheet and, in order to effect a balance, the assets of the subsidiaries have been written up above their cost to the subsidiary and likewise above the cost of the subsidiary's stock to the parent company. This is tantamount to a company writing up its own assets on an entirely arbitrary basis and without disclosure.

CONSOLIDATING ACCOUNTS OF DIFFERENT FISCAL PERIODS

There seems to be no substantial objection to consolidating for informative purposes two balance-sheets of different dates, when the consolidated picture thus shown is not materially different from what it would probably have been had it been feasible to use the same date for both companies.

As a matter of fact, prospective investors would get a more informing presentation of the situation after the consolidation is effected than they would if merely separate balance-sheets were shown. This seems to be a case where pure technique yields to practical considerations.

If the balance-sheet dates are separated by a considerable period, if differences in seasonal conditions at the respective dates cause the balance-sheets to be on dissimilar bases, or if there are other causes which tend to create a divergence of basis because the balance-sheets are not as at precisely the same date, a consolidated balance-sheet would not be justified.

The test would be what has been indicated above, viz.: (1) Are the balance-sheets in such relation to each other that a distorted picture would not result from consolidating them; and (2)

Does the consolidated balance-sheet tend to result in a more informing picture than the separate balance-sheets?

A firm or exclusive rule can not be laid down for this class of cases. The special circumstances of each case must determine the course to be followed. Strict adherence to technique should not, however, be at the expense of practical benefits that may follow from a relatively immaterial departure from technicality.

ACQUISITION OF SUBSIDIARY "AS AT" AN EARLIER DATE

The stock of a subsidiary is often acquired as at an earlier date, and a question arises as to the date to be used in determining surplus at acquisition and the earnings of the subsidiary to be included in consolidated income. The guiding principle here is whether or not the circumstances indicate that the earnings subsequent to the "as at" date were considered in determining the purchase price, since if the subsidiary's earnings have been paid for they clearly can not constitute part of the consolidated earned surplus.

Where, for example, an agreement to purchase the stock at a stipulated price is signed on June 30th, contingent upon an audit supporting the accuracy of the accounts and, because of the time required for the audit and legal details, title to the stock does not pass until August 31st, it is entirely proper to treat the acquisition as of June 30th. On the other hand, if negotiations for the purchase of stock begin on March 31st based on a previous December 31st balance-sheet, it is reasonable to assume that the earnings between December 31st and March 31st have an effect upon the purchase price, and even though the transfer is made "as at" December 31st, it would be incorrect to include the earnings for the three months in consolidated earned surplus.

Where a negligible period intervenes between the "as at" date and the actual date of acquisition, it may be ignored for practical reasons. This should not, however, be regarded as modifying the principle generally applicable.

Where the circumstances do not justify treating the "as at" date as the acquisition date, the income and expenses of the subsidiary are often included in the consolidated income account for the full period and the portion of the subsidiary's net income applicable to the pre-acquisition period is then deducted in one amount before the transfer of the consolidated net income to consolidated earned surplus. This not only simplifies preparation of the statements but gives a better indication of earnings on a recurring basis.

In some cases modified statements are prepared, giving effect to the acquisition as at the beginning of the period of all companies acquired during the period. In such cases it is important to avoid the duplication of income which would result from the inclusion in the consolidated earnings of both (a) the earnings of a subsidiary for the period between the "as at" date and the actual date of acquisition and (b) the income derived by the parent company during the same period from the assets used to acquire the subsidiary's stock.

The United States treasury, for statutory reasons, has never recognized "as at" transactions for income-tax purposes. Subsidiary companies can be included in consolidated income-tax returns only from the date when actual ownership of the subsidiary's stock is acquired, unless the pre-acquisition period is less than thirty-one days.

FOREIGN SUBSIDIARIES

Affiliated groups which include foreign subsidiaries offer special problems, not so much because of the difficulty in stating abstract principles as because of the difficulty of practical application and the element of foreign exchange, especially if the currencies of a number of different countries are involved, particularly when there has been considerable fluctuation in exchange. When the foreign subsidiaries are actually consolidated with the accounts of the parent company, good practice calls for valuing the current assets and liabilities at the rate of exchange obtaining at or about the date of the balance-sheet. As to the fixed assets, however, the more general practice is to use the rate of exchange obtaining at the time of acquisition or construction of such assets.

There is also involved the matter of making provision for American taxes which would become payable if undivided profits of the foreign subsidiaries were brought to this country. The practice on this point is not entirely settled and the question is complicated by the fact that the transfer of profits may be deferred to subsequent years, and the rate of tax, or even the classes of taxes, applicable at that time can not now be definitely foreseen. There is also an offset against American income tax on the foreign profits transferred for foreign income tax paid thereon, though such offset is limited to the rate of American income tax payable on such profits. Still further, some of the profits may never be transferred, if they have been invested in plant or if the business has been so expanded that increased working capital is permanently required abroad. To the extent, however, that earnings would be available for transfer to America, and taxes would be payable thereon in excess of probable credits applicable to such transfers, the better practice is to provide for such taxes in preparing the consolidated income account and balance-sheet, or to indicate by a note that no provision has been made.

INTERCOMPANY SECURITY TRANSACTIONS

A question which must occasionally be dealt with is: When and how to adjust for premiums or discounts upon reacquisition of securities of the affiliated group, especially when the company acquiring them is not the issuing company. From the standpoint of a consolidated balance-sheet it would seem that the same general principles would govern the adjustments for premiums or discounts in transactions of this kind as apply in the case of a single company reacquiring its own securities. If bonds are acquired, with no intention of resale, the substance of the transaction is that a liability is being discharged. If the bonds have been purchased at a discount, the credit arising therefrom should first be applied to extinguish any unamortized bond discount or expense carried with respect to such securities. If the reacquisition discount exceeds such unamortized discount, the excess is a non-operating item of gain for the year and, if of unusual amount, it should be set out separately. It may even be desirable to credit the amount directly to earned surplus because of the special nature of the transaction.

If a premium of material amount has been paid on bonds acquired, it should be charged against the consolidated surplus; if not appreciable in amount, it may be charged against the current year's income account.

It has been argued that when a parent company acquires outstanding bonds of a subsidiary, any premium paid represents additional cost of the subsidiary to the parent company. This is based on the theory that it is immaterial whether all of the securities of the subsidiary are acquired at one time or at different times. The argument, however, does not appear sound. The consolidated balance-sheet prior to the purchase of the bonds disclosed certain assets and a liability for the face amount of the bonds. No new asset is acquired, and nothing is added to the value of the assets already owned by discharging the liability for a larger amount in advance of its due date.

Nor would it seem desirable, or even correct, to carry the premium and amortize it over the remaining life of the bonds, because from a consolidated standpoint cash has been withdrawn from the business to discharge the liability and the transaction is a closed one which should have no effect on future income accounts. There may be an exception when bonds are retired at a premium in order to issue new bonds at a lower interest rate. In such circumstances there is considerable justification for spreading the premium over the life of the new issue so that it will be charged against the periods benefited.

In the event that capital stock of either the parent company or of its subsidiaries is acquired, any profit thereon should be credited to capital surplus.* The New York stock exchange in its recent publications holds that a transaction in a company's own capital stock does not give rise to earned surplus. An exception would doubtless be conceded in a case where preferred stock has been sold at a discount and such discount was charged against earned surplus. Any discount realized on the reacquisition of such stock represents a recovery of the previous charge to earned surplus and to that extent is a proper credit thereto. In those cases where preferred stock is retired at a stipulated premium, the premium is in the nature of a supplemental dividend or compensation to the preferred stockholder for the use of his capital, and in such cases would properly be charged to earned surplus as in the case of ordinary dividends.

There is not as yet complete agreement with the position taken by the stock exchange that a profit on the purchase and sale by a corporation of its own stock in all circumstances represents capital surplus. When a company, either directly or through a subsidiary, actually trades in its own stock, it is difficult to distinguish between the trading profit so derived and a profit derived from trading in the stock of an unrelated company.

PLEDGE OF INTERCOMPANY SECURITIES

At a meeting of the Robert Morris Associates held within the past year, the question was raised whether in the case of a parent

* There may be circumstances in which the profit on reacquired capital stock, especially if originally issued for property other than cash, should be credited to some asset account rather than to surplus. See Montgomery's *Auditing Theory and Practice* (4th Ed.) page 244 et seq.

company having a bond issue outstanding, which is secured by the entire capital stock of one or more of the subsidiary companies whose accounts were included in the consolidated balance-sheet, it is required that the pledging of the subsidiary stocks should be indicated on the balance-sheet. In view of the fact that the accounts of the subsidiaries are consolidated with those of the parent company, the stocks of the subsidiary companies do not appear as such on the balance-sheet.

In considering this question, it should not be overlooked that consolidated balance-sheets do not usually purport to set forth the relative positions of different classes of creditors. Consolidated balance-sheets are not necessarily sufficient in themselves for credit purposes, and balance-sheets for some, if not all, of the separate corporations included in an affiliated or controlled group frequently need to be secured by the lender to supplement consolidated statements submitted to him. The general rule of the Federal Reserve bank of New York is that both a balance-sheet of the borrowing company and a consolidated statement, if the borrowing company is one of an affiliated group, are required. It is to be noted that several large public-utility corporations now publish both an unconsolidated balance-sheet of the parent company and a consolidated balance-sheet of the parent and its subsidiary and affiliated corporations. This has not yet, however, become general corporate practice.

A study of a number of balance-sheets, which showed mortgage and collateral note issues that were obviously secured by collateral, consisting of the stock and/or obligations of subsidiaries, indicated that at the present time it is not the practice to show on a balance-sheet the various collateral securing such issues. Bankers are on notice that if a collateral note issue appears among the liabilities on the consolidated balance-sheet, there is collateral, and that it may be composed of a great many items, including capital stock of subsidiary companies.

SALE OF SUBSIDIARY

When the stock of a subsidiary is sold during the year, it is proper to include in the consolidated income account the earnings of such subsidiary for the period during which it was a member of the affiliated group, but if the subsidiary is a substantial one, the financial statements should disclose the facts.

In determining the gain or loss on the sale for the purpose of the consolidated accounts, the basis should be the cost of the subsidiary's stock to the parent company increased by the parent company's share of the subsidiary's earnings since acquisition, as reflected in the consolidated surplus account, or decreased by the losses of the subsidiary as so reflected. In either case allowance would also have to be made for any dividends received by the parent from the subsidiary. There have been cases where an apparent loss was realized upon the sale of a subsidiary but, after adjusting the basis by the amount of the subsidiary's losses, a profit actually resulted from the sale. Under an inequitable feature of the present income-tax regulations relating to consolidated returns, the earnings of the subsidiary since acquisition can not be added to the tax basis, but in general the losses of the subsidiary must be deducted from the basis.

In adjusting the consolidated balance-sheet to reflect the disposition of the subsidiary, any consolidating entries previously made to absorb the difference between the purchase price of the subsidiary and its net assets, such as debits to goodwill or capital surplus, must of course be reversed.

PROVISION FOR MINORITY INTEREST IN EARNINGS

An affiliated group includes one subsidiary in which the parent company owns all of the cumulative preferred stock and 75 per cent. of the common stock. The subsidiary company, until last year, had consistently been showing losses and consequently dividends had not been paid on the preferred stock. In 1930, the subsidiary showed a substantial profit, and the question arose whether, in preparing the consolidated income account and the consolidated balance-sheet, any part of these profits should be allocated to the common-stock minority interests.

The common stockholders do not have any equity in the earnings until the earnings have reached an amount where they are sufficient to cover the accumulated dividends on the preferred stock. In a year in which the company made a profit in excess of the annual dividend on the preferred stock, but no part of the profit accrued to the common stock because of the unsatisfied claim of the preferred stock to cumulative dividends in prior years, the situation with respect to the consolidated income account is the same as though the parent company had owned none of the common stock but was receiving during the current year back dividends on its preferred holdings in addition to the current dividend. Where the collection of back dividends is a large enough item to affect materially the amount of the consolidated income, because no provision was made for the common-stock minority interest in profits, a proper memorandum might well be made on the statement. However, it would have to be a rather aggravated situation where the question would practically arise.

INTERCOMPANY PROFITS IN THE CASE OF PARTLY OWNED SUBSIDIARIES

When a portion of the stock of a subsidiary is not owned within the affiliated group, the proportionate part of any intercompany profit is earned and accrues to the minority stock outstanding. Consequently, the elimination of intercompany profit should be made only to the extent that the stock of the subsidiaries affected is owned within the group.

This point most often arises in relation to inventories. When the minority stock outstanding is small, this adjustment of the elimination may well be disregarded as the only effect of disregarding it is to reduce slightly the inventory (or other asset affected) and correspondingly the book value of the minority stock. Where, however, the minority interest outstanding is substantial, the adjustment referred to should be made.

It need hardly be mentioned that in making such an adjustment the amount of intercompany profit to be dealt with will be only the amount remaining in the inventory after applying the usual rule of "cost or market, whichever is lower." Further, "market" in such case is the replacement cost to the vendor affiliate and not to the vendee, and such replacement cost must also not be in excess of the prospective selling price.

INTERCOMPANY INVENTORY PROFITS AT DATE OF ACQUISITION

When companies become affiliated which have previously been doing business with each other the problem at times arises as to the treatment of their combined inventories in the initial consolidated balance-sheet. The point has added importance because of its bearing on the consolidated income account for the first fiscal period of the affiliated companies.

Let us assume that Company A, which has been doing business with Company B for a number of years but has heretofore had no financial interest in B, acquires the latter's capital stock.

Let us further assume that at the time of such acquisition B has in its inventory $100,000 of goods recently purchased from A and on the sale of which A had realized a gross profit of $20,000. The goods are in excellent condition, and had the two companies not become affiliated there would be no question whatever of their being worth fully $100,000 and of the profit of $20,000 having been fully earned by A. In the negotiations for the sale of the stock of B to A, the vendors naturally take the position that B has an asset which cost $100,000, which can not be replaced by B for less than that figure and in the ordinary course of business will realize the usual rate of profit thereon. Consequently, the vendors of B's stock insist that in fixing the price to be paid them the $100,000 of goods must be valued at that figure.

If, however, the goods referred to are included at $100,000 in the inventory in the initial consolidated balance-sheet, there will be a distortion of the operating income shown in the consolidated income account for the period immediately following affiliation. The intercompany profit at the close of that period will naturally be eliminated, and unless the $20,000 of profit paid to A by B on the $100,000 of goods included in the combined inventories at the date of affiliation is also eliminated from the opening inventory, the consolidated income will be understated by $20,000.

In effect, what happens is that the parent company A is accepting a return of $100,000 of goods which it had previously thought were definitely sold and are now coming back as an incident of the acquisition of the ownership of B. Assuming this as a premise, one procedure would be to charge the $20,000 against the surplus of A at the date it acquires the stock of B. The consolidated surplus would remain permanently reduced by this figure.

An alternative procedure would be to consider the $20,000 as part of the assets of B which are purchased by A through the acquisition of the stock of B, but to treat it as the cost of goodwill or other intangible asset. This would be on the theory that the acceptance of a return of the goods is a necessary condition of the acquisition of the stock of B, and the entire cost thereof is a capital investment, even though for a part of it, viz., $20,000, no tangible asset is received.

Although the first procedure outlined above is the more conservative of the two alternatives, the second seems to reflect more closely the actual situation and to be fully warranted in principle.

While the foregoing illustration has been based on the acquisition of the stock of one company by another, the principle would apply just as well to a case where two or more companies, which have been doing business with each other and have in their inventories goods acquired from each other, are consolidated through the acquisition of their stocks by a new holding company.

The Scope of the Small Accounting Firm *

BY CHARLES F. RITTENHOUSE

Your committee on meetings has asked me to discuss the scope of the small accounting firm from the point of view of the individual practitioner. In considering the subject from its various angles, it will be necessary to say a good deal about the relative status of the national and the local firm, and it therefore seems advisable at the outset to come to an understanding as to what we mean by these two types of firms. I shall assume, therefore, that in speaking of the small firm we have in mind the firm with only one office, with a well balanced staff of moderate size, with a local clientele and reputation, but at the same time, a firm of recognized standing, as contrasted with the national firm with a network of offices in the principal industrial centres of the country.

For some years, many of the smaller firms of accountants have seemed to view with some apprehension the growth in clientele and power and influence of firms engaged in practices national in scope. It appears that such firms enjoy a distinct advantage over the local practitioner from every point of view. Their clients are the nationally known companies which provide them with much free publicity and pay fees commensurate with their size. They obtain new clients with little or no effort. They enjoy the endorsement of leading banking institutions. The members of such firms number among their business and social acquaintances the influential men of the country. As the result, it would appear that the smaller firm is being crowded closer and closer to the wall and is finding it increasingly difficult to survive. While the national firms are growing larger and larger, the local ones may be in danger of becoming smaller and smaller.

As one hears this situation discussed at national conventions, at meetings of state societies, and among accountants generally, one obtains the impression that the local accountant is developing an inferiority complex, feels an increasing sense of insecurity, and has grave doubts about the future of the small practice.

It is possible that this subject was given a place on the programme this year because of a good deal of discussion which has taken place over a paper which was read at our annual meeting a

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* Address delivered at the annual meeting of the American Institute of Accountants, September 15, 1931, at Philadelphia, Pennsylvania.

year ago on the future of the small accounting firm. Those of us who listened to this paper, or who read it later in THE JOURNAL OF ACCOUNTANCY, felt that while its author attempted to prove that there is a place in our industrial life for the local firm, yet when judged by results and by the opinions of bankers and others whom he quoted, one could hardly avoid the conclusion that the small firm was contending against great odds. Consequently, it must have seemed advisable to the committee to bring this subject up for discussion again and to have the case presented from the point of view of both the small and the large firm.

In undertaking the task assigned to me, it was my original intention to confine my paper to a statement of my own opinions and convictions, but the longer I considered it, the more I became convinced that my own rather restricted horizon might give little weight to what I said. It seemed better to obtain, if possible, an expression of opinion from a fairly representative group of accountants in somewhat my own class. Consequently, with some misgivings and with fitting apologies, I prepared a questionnaire which I felt might assist the one who received it in formulating his opinion. This went to seventy-five firms and individuals whose practices were presumed to be largely local, with offices in forty-seven cities in every section of the United States, all of whom were members of the Institute.

The response to this questionnaire was most gratifying. Replies were received from forty-five men located in thirty-one different cities. With very few exceptions, the replies were not of the usual perfunctory type. The writers showed a keen interest in my undertaking, a careful and intelligent consideration of the questions, and their answers were expressed in such a forceful and effective manner that I have found them exceedingly helpful in crystallizing my own point of view. If this paper contains any merit, the credit therefor in no small degree belongs to the men who have coöperated so splendidly in stating their own ideas and experiences.

Since only seven questions were asked, I feel that it will be worth while to state them here and to give a brief digest of the answers received. As they are read, you will see that in accordance with my interpretation of the subject, my purpose was both to find out what effect national firms were having on local practices and also to obtain more light on just what may reasonably be assumed to be the scope of the small firm.

Question 1 was as follows:

"Have you experienced any appreciable loss of clients to national firms?"

To this question, twenty-three replied that they had lost clients and eighteen that they had not. Four made no direct reply. Even those who replied in the affirmative did not seem to have suffered very severely. Most of them said that they had lost one or two clients, or very few, or none of any consequence, or that they had suffered no material loss. One reported a loss of considerable consequence, another the loss of some very good clients, and one man reported the loss of 30 per cent. of his practice in the last three or four years.

Question 2 (referring to question 1) reads:

"If so, in your opinion what were the reasons? Was it due to direct or indirect solicitation, to a merger, to reorganization, new financing, a change of administrative personnel, commercial banking influence, or to some other cause?"

The twenty-three men who reported loss of clients to the national firms gave one or more of the reasons mentioned. The reasons most frequently given were solicitation of their business, consolidations, mergers and reorganizations. Among reasons given which were not suggested in the question, were requirements for listings of securities on the New York stock exchange, geographical distribution of branch offices requiring the services of a firm with offices in the larger cities, engagements too large for a local firm to handle, price cutting, sales of companies, dissatisfaction with local firms' services.

Question 3. "Has this tendency been strong enough to give you any concern about the security of the clientele of the small firm?"

Most of those replying stated most emphatically that they felt no such concern but that on the other hand they had every confidence in the permanence and continued growth of the small firm, that the future of the public accounting firm with a well organized staff of moderate size was never brighter, that there is a very definite function which the smaller firm can perform much better than the larger firm, and similar statements which showed the utmost faith in the security of the local firm.

Adversely, one man stated that he did not envy the position of the individual or small firm that is commencing its career today;

another, that he had some concern about the security of the clientele of the small firm due to the constant "hammering" by certain of the large firms; another, that the loss of clients had been so pronounced in his business that he viewed the situation with considerable alarm; and another, that he had a great deal of concern about the security of his clients and was of the opinion that the smaller firm must take the initiative in securing new engagements.

Question 4. "Have you observed any instances of what you would consider unfair practices on the part of the national firms by way of emphasis being placed on the value to the client of a widely known name, or by way of unfavorable comments on the limited experience and consequently restricted service which the local firm can render?"

A number of replies expressed in no uncertain terms their indignation over what they regarded as unfair and unethical practices indulged in by some of the larger firms. In order to present their feelings on this point more exactly, I quote from several letters.

One accountant states, "I do not believe that there is a national firm in the United States that is not guilty, directly or indirectly, of spreading propaganda with respect to the superiority of service rendered by the national firm over that rendered by the local accountant."

Another, "There have been several instances of direct solicitation of my clients without any other connection with the company than the knowledge that it exists."

Another, "One large firm does personal soliciting, quotes flat prices, very low in the first instance, and strongly urges the advantages of the national firm. They emphasize the broad experience they have had and offer service based on the experience of other concerns in the same line."

Again, "We have observed many instances that we would very emphatically consider unfair practice on the part of national firms by way of placing emphasis on the value to the client of a widely known name."

Another, "I think it is a habit of some of the members of large national firms to damn the smaller firm with faint praise."

Another, "Numerous instances have been observed where unfair and unsportsmanlike tactics were used and I much regret to state that the more flagrant ones were from sources which an Institute member would least expect."

Several others replied in the same vein, but there is not time to quote further.

On the other hand, eight men replied in substance that they had found the competition of the national firms most fair and that they felt that the opening of offices of national firms in their localities had been helpful to them in many ways.

In passing, one of the replies received had only an incidental bearing on the question, but the writer expressed an opinion relative to the professional aspect of the branch-office policy of the national firms with which I find myself in substantial agreement. Hence I shall supplement his ideas with comments of my own. This man said that we like to look to the national firms for guidance on professional matters. Most codes of ethics are sponsored by their members. Standards of practice and procedure have largely been formulated by them. But are not the national firms with their network of offices guilty of conducting their practices in a manner that no other profession would think of doing? The very essence of professional work is direct personal service. Personal service which is remote and detached loses much of its value and involves but a smaller measure of personal responsibility. Yet, national firms consisting of relatively few partners maintain that their work is professional even though their offices are spread over the country, and are mostly in charge of branch managers. It seems pertinent to raise the question as to the degree of personal attention of the members of the firm which the client's work receives in most of these cities.

The client in such cases may be getting excellent accounting service, but is it a professional service rendered by professional men personally responsible to the client? Is not the acceptance by the business public of the branch-office policy of our large accounting firms one of the reasons why we accountants are so hard pressed in our efforts to persuade the world that we are professional men? Isn't this why so many of our clients and banker friends can not understand that we are any different from engineering firms and appraisal companies? Isn't this why we are constantly advised to advertise, or to supply our clients with a bulletin service, or to engage in some other publicity work, by men who would not think of advising a lawyer or a doctor to do the same thing? The branch-office policy of the national firms has put us in a class with the appraisal companies in the minds of the public, and there we are in danger of remaining so long as the national firms in their efforts to impress the public present an array of branches located in all the principal cities of the world.

I suggest that this is a point to which the national firms might well give serious reflection since they are the ones who are most insistent in their demands for professional recognition. Personally, I have never wasted much breath in attempting to persuade my friends that I am a professional man. If accounting is a profession, that fact will be recognized through our accomplishments and our conduct, without our being obliged repeatedly to tell the public so.

Question 5. "Has a case ever come to your attention of a national firm which had been asked to take over the client of a smaller firm, advising against the change?"

With two exceptions, the answers were "No."

I can not but believe, however, that this does happen a good many times. A generous deed of this nature is usually done by stealth and discovered only by accident. In an address before the New England regional meeting of the American Institute two years ago, the senior partner of an internationally known firm stated, "We have encouraged our clients more than once to retain the local accountants where we felt that there was reason to believe that the local accountant could render all the service that was required. We have never wished to grow at the expense of the local accountants. The loss to them is usually of greater consequence than the gain to us." No one who heard this man could doubt his truthfulness and sincerity.

Question 6. "Do you know of cases of clients who have changed from national firms to local accountants? If so, for what reasons?"

The greater number of the replies to the first part of this question were in the affirmative. The principal reasons given for such changes were that the clients felt that they would receive a much greater degree of personal service from the smaller firms and would also have a direct personal contact with the principals instead of with members of the staff only; that clients found that it was the usual practice of the large firms to assign different men to their audit each year, and they objected on the ground that they had to become acquainted with a new group of men each year, and that this, to their minds, added to the expense of the audit. By giving their work to a local firm, they expected to enjoy the continuous service of the same men and would also have direct contact with the principal. They also felt that the smaller firms were able to do fully as satisfactory work for smaller fees because of less overhead.

Another reason given was that the seniors assigned to the work by the larger firms seemed to be compelled to follow a set procedure in making the audit, which procedure required the detailed checking of every transaction and the spending of much time on what the client regarded as non-essentials. Because of being obliged to follow a stereotyped programme prescribed by the home office, he was not able to exercise his own initiative, or to use his own judgment.

Question 7. "What, in your opinion, can the local firm do to maintain and strengthen its professional standing in the community?"

The answers to this question present quite a formidable array of suggestions, many of which are trite, it is true, but nevertheless, sufficiently sound to merit repetition.

Almost everyone stressed the necessity of doing work of such a thorough and responsible nature as to earn the confidence and loyal support of the client, his business associates, his banker and his attorney.

Three expressed themselves as having no sympathy with the rigid restrictions of the Institute relative to personal solicitation and to advertising of a dignified and constructive character. They feel that the accountant is able to render a service which should prove valuable to clients in many ways. He knows of many concerns which need such service and which have never employed accountants. Why is it, then, that he is barred from telling such companies about the service which he can render?

Many stressed the advantages of taking an active part in civic affairs and in giving freely of one's time and money in fostering and promoting worthwhile community activities, of belonging to one or more good clubs, of finding time for mingling with men of affairs, and of seeking through every natural and legitimate channel to earn the esteem, respect and confidence of his community.

Several deplored the fact that so few of the members of the smaller firms take an active part in the affairs of our state and national societies. The smaller accountants so often give as an excuse for not attending meetings of their state societies and national associations that these societies are dominated by the members of the larger firms. In passing, it is needless to say that this is a weak alibi. The membership of the Institute, as well as of all other national and state organizations, consists largely of members of local firms and individual practitioners and, if there is any danger of the domination of the national firms, the blame rests solely with us.

A number stressed the prestige which membership in the Institute carries with it and the recognition given to such an affiliation in financial circles.

Others felt that it is a mistake to place fees above every other consideration. Like the doctor or lawyer, the accountant must expect to render some gratuitous service and to work on occasion for nominal fees.

Several stressed the need of restrictive legislation which would either drive out of practice or place under the control of a supervisory board all uncertified public accountants operating largely as individuals, with limited education and with no technical training, with limited experience, and with no standing in the community, but who, by persistent effort, succeed in getting work at low rates, but which is often performed in such a manner as to bring discredit upon the legitimate members of the profession.

Again, it was urged that the principal often does not cultivate and maintain a sufficiently close personal contact with the client. He views his work largely as that of an executive, and, as such, spends most of his time in his own office. If he were to have frequent personal contacts with the client and were able to show an intimate knowledge of his business and of the problems which confront him, and to make helpful suggestions for solving them, the bond with the client would be greatly strengthened.

Many reminded us that it goes without saying that an accountant must be of the highest integrity, must be upright and straightforward in all of his relations, and must conduct himself as a gentleman. But, in addition to these, he must cultivate a forceful and convincing manner, be fearless and plain-spoken when occasion demands, be able to state his case clearly and convincingly, and must be open-minded and sympathetic.

I have attempted to give you a digest of the opinions and experiences of a group of public accountants representing, to my mind, a very good cross-section of the profession. What conclusions may be drawn therefrom? What may we reasonably expect the future of the small accounting firm to be, and what is the scope of its work? If I am able to analyze the ideas of this group and to supplement them by my own convictions, the answers to these questions may be rather definitely stated.

The future of the local accountant is secure. His prospects for growth in clientele and prestige, within certain limitations, were never brighter. The scope of his work is as broad as his own ability and professional standing are capable of making it. There need be and should be no conflict between the large and the small firm. Their relations are in no sense antagonistic. Their interests are not incompatible. Friendly competition between them there will always be. That the local firm will lose clients, on occasion, to the national firm, is inevitable. When these losses are due to economic trends, they should give us no serious concern. The small firm can not stop economic trends, nor can the larger firm create them. The small firm will continue to lose clients because of personal or banking or legal influence, and this must be accepted in good grace. If the loss of a client is due to unsatisfactory work, the small firm has only itself to blame.

The size of a practice is not the sole measure of success. Size is relative. The national firms of today all had their beginnings as small firms, and likewise, there are firms whose practices are now entirely local in scope which will achieve national prominence in the future. In our several localities, many a one-man office doubtless on occasion complains bitterly about the loss of clients to a local firm of the type which I am discussing, but that one-man office may develop rapidly into a practice of some size.

To my mind, the thing which counts far more than the number of clients is the quality of the service rendered. The man with the smaller practice contributing the best service of which he is capable, with a conscientious regard for the interests of his client, even though his financial reward may be a modest one, is successful in the true sense of the word. Many factors contribute to the size and importance of a clientele. Accountants, like other professional men, possess varying degrees of intelligence, experience, charm of manner, social standing, wealth, industry, selling ability, and the faculty of leadership, and they differ widely in their ability to inspire confidence. The vicissitudes of fortune or fate, the locality in which one conducts his practice, and various other elements, all have their bearing.

We should have no quarrel with ourselves or with others if we are not successful in building up a practice of a size and quality which we see others enjoying. It may not be the privilege of the small firm to delve into the financial secrets of big business, to associate on the golf links and in the clubs with captains of industry, to revel in the realms of figures that run into the millions and hundreds of millions, to see our certificates attached to the published annual reports of companies of international importance, or to figure in newspaper headlines.

But, there are compensations. While our sphere of usefulness is smaller, it is equally important. Many of us take a pardonable pride in building up a practice under our own name, even though it may not be a large one, or we take a keen satisfaction in being at the head, or somewhere near the head, of a practice, rather than a somewhat detached partner or branch manager in a national firm. We feel that there is a much greater opportunity for genuine service to management growing out of our contacts with the smaller industrial concerns than is afforded by the companies of national size and importance. The large industrial companies not infrequently do not take too seriously the work of their outside auditors. The men engaged on such an audit in many cases do not measure up in ability and experience to the accountants, auditors and comptrollers on their own payroll. Such companies regard the audit as the perfunctory procedure which must be followed in obtaining a name to the balance-sheet which accompanies their annual report. The owners or executives of a smaller concern, on the other hand, look upon the outside auditor as at least their equal. They seek his counsel, discuss with him the most intimate details of their business, ask advice on business and financial policies, and seek assistance on personal problems. The result is that the relationship, as the years go by, comes to resemble very closely that existing with their family doctor or lawyer.

We have not the personnel problems of the large firms. We can more easily contract our organization and reduce our overhead in periods of depression. We seem to escape the costly litigation in which the large firms from time to time become involved. In the national firm, the name of the firm too frequently overshadows the members who compose it, whereas in the smaller firm, the partners may enjoy a personal standing and prestige which may even overshadow the firm itself. We are, unquestionably, more independent and have a greater feeling of choice in our comings and goings, in the planning of our leisure time, and in our personal and social contacts, than if we were constantly striving to measure up to the professional and social standard expected of a member of a national firm.

Whatever success we achieve redounds largely to our personal credit rather than contributing to the established reputation of the firm. We can look about us in our respective communities and see the direct results of our work in better managed and more prosperous companies, in companies which enjoy more satisfactory lines of credit, in companies better organized for profit.

Finally, we challenge most openly and emphatically the argument sometimes advanced that the large firms are capable of doing more thorough and accurate work and that they are less likely to prepare statements which do not tell the whole truth, or to become "too pliant with the wishes of those in authority," to quote from the justice's charge to the jury in a recent English case. Indeed, if we may judge from certain things which have come to light in recent court cases, the shoe may be on the other foot.

In all of this discussion, however, we must not overlook the fact that we owe much of our professional advancement to the members of the national firms. These firms have done a great work in educating the business public to the value of the service which the accountant can render. In no small degree, they deserve the credit for raising the accounting profession to the point where it so generally enjoys the respect and confidence of management. They have been among the leaders in our educational advancement. We owe a debt of gratitude to the many members of the large firms that have contributed time and money without stint to the cause which they represent. We recognize and respect them as educated men of wide influence, of broad experience, and as the leaders in the profession to which we belong.

To paraphrase certain remarks from the address to which I previously referred, the large firms, in no small degree, fight the battles of the entire profession. They are likely to take a stronger stand on questions of principle. They make the major contribution to the literature of our profession, and to sound legislation, and they are in a position to devote their time and energies in a much larger degree to the upbuilding of the profession as a whole.

On the other hand, the smaller firm all too often falls short of living up to its greatest opportunities. I have already mentioned many helpful suggestions contained in the letters which were received, for strengthening the position of the small firm. To a much greater extent, we could follow the examples of the leaders of the profession. To repeat, we could display a much keener interest in local society activities, and in the work of the national organizations. I have always felt that it was a serious indictment of the rank and file of our profession to see in the membership roster of the Institute such a small proportion of the men engaged in public practice who possess the necessary qualifications for membership, and to see in attendance at these national conventions so small a proportion even of the membership.

We can take a much more active part in promoting sound legislation. In our local communities we can do a great work in our conferences with bankers, in getting across to them that a great deal of general education, technical training, experience, judgment and common sense goes into every piece of accounting work that is undertaken. Many bankers seem unable to value accounting work. They seem to think that, given a certain array of figures and facts, Accountant A or B or C or D will be certain to arrive at the same results and conclusions. Educating the bankers and the business public away from this point of view is a task that can best be accomplished by the individual accountants in their own communities and among their own clients.

We can contribute more freely of our knowledge and experience to the business and accounting magazines and to trade journals.

There should be a freer interchange and exchange of ideas and experiences among local firms. We should show a greater degree of frankness in discussing with each other actual conditions encountered on an engagement, and much more of a tendency to consult each other over controversial points. There is little doubt that if one went to any other accountant in his community to seek advice on any point, he would obtain the best advice of which the man consulted is capable.

The younger men in the legal fraternity do this constantly. They repeatedly arrange for another lawyer to appear with them as senior counsel or as assistant counsel in order that the client's case may benefit from the added experience and knowledge of the older man. But accountants seem most reluctant to admit the need of help on an engagement which they have undertaken. Either that, or they are too timid to ask for it. As a result, the man just starting in practice too often plods along by himself, plans his own programme, carries out his own procedure, acts as his own supervisor, edits and verifies his own report, and is the sole authority on all points at issue. The finished product too often shows the limitations of his knowledge and experience, and it passes into circulation with discredit not only to himself but to his fellow practitioners.

The incompetent and inexperienced public accountant, often not a certified man, or not a member of the Institute, is much more of a menace to the growth and prestige of the local firm than the national firm.

As a further development in the scope and type of work of the local firm, I am of the opinion that in the future, we shall see much more of a tendency toward specialization in some particular phase of accounting work or in some one line of business.

In conclusion, I am convinced that every local accountant with faith in his work and confidence in his ability to render a genuine service to industry is able to face the future with every assurance that there is an enduring place for the local firm and a growing need for its services. True, from time to time, we shall lose clients, and often clients of some size, due to circumstances beyond our control. True, we shall meet with competition from the national firms, on the one hand, and the irresponsible free lance, on the other, but I venture to say that the local firms know nothing about competition as compared with what the national firms could tell us, if they would. For every client lost, there are scores of industries still to be convinced that we can be of help to them in solving their management problems, and new scores of industries are springing up on all sides. Ten clients paying an average fee of $1,000 per year each give much more stability to a practice than one paying a fee of $10,000.

Our most fertile field is that occupied by the smaller industrial concerns, the one-man companies which need management service more than they need audits for credit purposes or as insurance against dishonesty of employees. Such service, the local accountant is, or should be, much better able to render than the branch office of a national firm, and at a fee commensurate with the size and profitableness of the business. If we can assist a young concern in its struggle to secure a stronger foothold, or can aid a sick company to find the road back to health and prosperity, it gives us a much keener satisfaction than we derive from installing an accounting system or establishing the amount of a defalcation. Furthermore, if we are reasonably successful in such undertakings, we need have no fear about the future of our practice.

The strength and stability of the industrial life of our country is to be found in the thousands of successfully managed concerns of moderate size, found in every village, town and city of our country. Notwithstanding the growth of great concerns, America is still the home of small industries. Despite the publicity given to huge manufacturing organizations, chain stores, and other great combinations of capital and ability, countless smaller concerns unknown outside their own communities are doing business alongside them and making it pay. The 1,000 odd corporations whose stocks are listed on the New York stock exchange, some portion of which, no doubt, represent the cream of the clientele of the national firms, are not significant so far as numbers go when we remind ourselves that there are more domestic business corporations in New York state alone than are listed on the exchange.

Many of our business leaders are convinced that the tidal wave of mergers and consolidations reached its highest point at the close of the last decade, and that there is at present a decided swing of the pendulum in the other direction. Mergers are at a standstill, and with them have disappeared the fat fees of many firms. Many of the scrambling jobs of those days face an unscrambling process. America will become more than ever before the land of opportunity to the man who would conduct a business of his own, rather than become a hired hand in some great concern.

As in industry so in accounting, the strength and stability of the profession and the assurance of its continued growth, lie in the faith, the steadfastness and the sincerity of purpose of the local firms scattered over this great country.

Government Regulation of Railroad Finances *

By Emory R. Johnson

A justification for the discussion of the government regulation of railroad finances is found in the very size of the task. The official valuation placed upon railroad property in the United States is approximately twenty-five billion dollars. The reproduction cost of this property would probably be once and a half the official valuation. To maintain this property and to keep it abreast of technical requirements and to provide for necessary new facilities requires an annual investment of seven hundred fifty million dollars.

The importance of the government regulation of railroad finances grows out of the fact that the railroads and other agencies of transportation are a fundamental and vital necessity. Upon adequate transportation depends the welfare of society, economic activity and progress, and the stability and efficiency of governmental administration. These facts have been so often set forth that it is necessary only to refer to them without discussion.

The reasons why the government of the United States has undertaken the regulation of the finances of railroads are to be found partly in the facts just stated. The railroads are one of the essential utilities by which the public is served. Indeed, the railroads are the most important of all the utilities, and their financial administration and development are of concern to the entire public. Moreover, the investments in the railroads, both by private individuals and by fiduciary institutions should, in the interest of the public, be as safe, stable and non-speculative as is practicable to make such investments by wise government supervision. At the present moment insurance companies, trust companies and other similar institutions are much concerned as to the financial condition of American railroads.

The government regulation of railroad finances began with the regulation of railroad accounts. The original interstate commerce act of 1887 gave the interstate commerce commission authority over the accounts of the carriers subject to the act; but, as no provision was made for enforcing any system of accounts that might be prescribed by the commission, no system was

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prescribed and the accounts remained unregulated until the passage of the Hepburn act in 1906. This act gave the commission the power not only to prescribe but to enforce uniform accounts and with the coöperation of the Association of Railway Accountants, the commission, with the expert assistance of Henry Carter Adams of the University of Michigan, worked out a uniform system of accounts first for the railroads and then for other carriers subject to the interstate commerce act. Dr. Adams remained at the head of the bureau of accounts of the commission for a number of years, and to his wisdom and ability the subsequent success of the supervision of railroad accounting is largely due. The bureau of accounts of the interstate commerce commission has functioned successfully and with the complete coöperation of the carriers subject to the commission.

Further indirect control by the interstate commerce commission of the finances of railroads was given by the Mann-Elkins act of 1910 which gave the commission practically complete authority over the revenues of the carriers. The Hepburn act had given the commission the power to fix a maximum rate upon the complaint of an interested party. The Mann-Elkins act gave the commission not only the authority to consider rates upon its own initiative, but the still more important power of suspending proposed rates until the commission was satisfied that the rates in question should go into effect. Ten years later, by the transportation act of 1920, the commission was given authority over minimum rates and at the present time it is the commission rather than the railroad directorates that determines rate levels and consequently the revenues of the carriers.

The direct regulation by the government of railroad finances was provided for by the transportation act of 1920, but one needs to go back ten years to discover the origin of the provisions of that act. When at the close of 1909 the Taft administration recommended to congress amendments to strengthen the interstate commerce act one recommendation was that the commission be given authority to regulate railroad finances. The opposition in congress prevented the adoption of this recommendation, but President Taft was authorized to appoint a commission to investigate and report upon the subject of the government regulation of railroad finances. The chairman of the commission appointed was President Arthur T. Hadley, of Yale University. Under his very conservative leadership, the Hadley commission recommended publicity of railroad finances without government regulation.

Some of the states provided for the publicity of the facts regarding the issue of railroad securities, but publicity proved ineffective. Indeed, experience showed that the states, no matter how thoroughly they might regulate the issue of railroad securities, were unable to deal effectively with the problem. This was shown by the action taken by the Mellon administration of the New York, New Haven and Hartford Railroad. The state of Massachusetts and the state of New York had provided for the regulation of the issue of railroad securities but the New Haven railroad was a Connecticut corporation and Connecticut had not provided for the regulation of railroad finances. Mellon was thus able to issue new stock without government restraint and the debacle that followed is well known.

The transportation act of 1920 provided for a comprehensive and complete regulation of railroad finances by the federal government. There are indeed four phases of the government regulation of railroad finances under the act of 1920:

First—The construction of new lines, and thus the expenditure of funds therefor, must meet with the approval of the commission and every railroad company is obliged to prove conclusively that public convenience and necessity require the proposed construction.

Second—The interstate commerce commission must give its approval to the abandonment of lines in existence. This is in effect a negative regulation of railroad finances because it gives the commission authority to require a railroad to spend such funds as may be necessary to maintain unprofitable branches or facilities whose operation in the judgment of the commission, is necessary to the public.

Third—The act of 1920 gives the commission complete authority over railroad consolidation and the financing of such consolidation. The purchase of one railroad by another must be approved by the commission. If securities need to be issued to effect the purchase such securities must be passed upon by the commission. If two or more railroads are consolidated into one system the capital of the consolidated system must not exceed the aggregate value of the properties brought together. Indeed, it is not an exaggeration to say that the real regulation of consolidation is through the commission's control of the financial operation involved in consolidation.

Fourth,—and principally—The act of 1920 provides for the regulation of railroad finances by giving the interstate commerce commission authority over the issue of securities. It is interesting to note what the policy of the interstate commerce commission has been as regards the regulation of railroad securities. As would naturally be expected, the commission at first acted by approving or denying applications without suggesting modifications of the applications. Regulation was thus negative rather than constructive in character. Within a few years, however, it became more and more the policy of the commission to fix a price at which bonds might be offered for sale if their issue was approved by the commission. The commission thus substituted its judgment for that of the railroad directorates as to financial policy. In view of the fact that market levels seldom remain stationary for any considerable length of time it is necessary for the commission to act promptly upon applications for the issue of securities if the commission is to determine closely the price within which such securities shall be marketed. It is to the credit of the commission that it has acted promptly and I think it will be generally agreed that on the whole the commission has acted wisely. The third stage of the policy of the commission in the regulation of railroad securities has been the exercise of its judgment as to the kind of securities that may be issued, whether and to what extent securities shall consist of stocks or of bonds. In many instances the commission has required the applicants to substitute stocks in part or in whole for proposed issues of bonds. Here again the commission is substituting its judgment for that of railroad directorates as to financial policy.

What should be the policy of the interstate commerce commission as to the regulation of railroad finances? What is required in the public interest? There are at least five requirements:

The first necessity of the railroads is adequate revenues. Indeed, the regulation of railroad finances begins with the regulation of railroad rates and other sources of revenue. The transportation act of 1920 gives the commission the mandate to establish and adjust rates so as to yield carriers, under economical and efficient management, a reasonable return upon a fair value of their property. The commission is to fix a fair value and the annual rate of return. The commission has made a tentative valuation of the railroads and has established 5¾ per cent. as a reasonable annual return upon such value. As is well known, however, economic conditions have prevented the carriers from obtaining this rate of earning. At the present moment they are probably securing less than a third of 5¾ per cent. per annum upon the value of the property used in the service of the public. Presumably present conditions are temporary and railroads as well as other industries will see better days in the not distant future.

Second, another requirement as to government regulation of railroad finances is that the government requirements as to expenditures by the carriers shall be reasonable. The interstate commerce act as amended to date gives the interstate commerce commission authority in numerous instances to require expenditures on the part of the carriers. On the whole, the commission's policy has been conservative and there have been but few complaints on the part of the carriers as to the commission's requirements. Indeed, the commission has more often prevented railroad corporations from making expenditures than it has made demands upon the carriers for outlays to carry out the provisions of the interstate commerce act.

A third requirement as to railroad finances is that the taxation of the railroads shall be equitable as compared with other properties and particularly as between the railroads and other competing carriers. Railroad taxes have risen year by year until 5 per cent. or more of railroad revenues is taken by the government. During the current year the government will take more than that percentage of the railroad revenues. This again is a temporary situation, but in the public interest it seems that federal, state and local governments should give serious consideration to the tax burden they are placing upon American railroads.

A fourth requirement as to the policy to be pursued in the regulation of railroad finances is that such regulation should be constructive and affirmative rather than negative as regards railroad consolidation. While it is realized now that more was expected in 1920 of railroad consolidation than it was possible to obtain, it is, nevertheless, true today that substantial economies of operation, administration and finance would result from the grouping of the railroads of the United States into a limited number of large systems of relatively equal financial strength and operating efficiency. The attitude of the interstate commerce commission towards proposed consolidations has become increasingly critical year by year and, on the whole, its present policy is more negative than constructive. This is unfortunate.

Fifth—It is of supreme importance that in the government regulation of railroad finances there should not be an undue limitation placed upon private initiative. The government should not take over the financing of railroads. The railroad directorates should continue to exercise their business judgment as to what is or is not wise. The substitution of government for private ownership and management of railroads would be a great mistake. To carry the government regulation of railroad finances to the point of substituting complete governmental control for private control of railway financiering would be disastrous to the development of American railroads, at least as long as their ownership is left with private corporations. The general purpose of the government in the regulation of the finances of railroads should be to establish the rules and to allow the railroads to play the game according to those rules. The railroad directors and officers should be in the game, the government officers on the sidelines.

What Should Be Included in Current Assets*

By Anson Herrick

At first glance the question of what should be included in current assets may appear distinctly elementary but scrutiny and consideration will indicate that it is not as simple as it might seem. The subject contains much meat for discussion and there are many controversial points which usually will be found to involve questions of theory versus desirable practice or expediency. It seems a particularly pertinent subject for present discussion, for the current section of a balance-sheet is of predominant interest and importance to the banker. A review of the principles involved and an exchange of views upon the subject should be of benefit to both banker and accountant, both of whom, I fear, too frequently ignore the wisdom of attempting to view a controversial subject through the eyes of the other. While the discussion is intended to be restricted to current assets, the relationship between current assets and current liabilities and the proper bearing of one upon the other will make it desirable to bring certain phases of the liabilities into the discussion.

Before entering into the details of what should or should not be included within current assets it will be well to establish a basis by presenting a general definition of what I mean by the term. I consider the term to mean those assets employed in and comprising a necessary part of the trading or operating cycle of an enterprise, as opposed to those assets *with which* an enterprise operates. This definition may require an explanation of the use of the words "trading or operating cycle." Every trading or operating transaction begins and ends with money. Money is exchanged for merchandise or for raw material and labor to produce a finished product or for labor alone to produce a service. The finished product or the service then is exchanged for an account receivable which, in its collection, is exchanged for money, thus completing the cycle; and if the cycle be a successful one the money at the end will be greater than the money in the beginning, the excess being the profit. Having in mind this cycle, we find that current assets embrace all property concerned

*An outline presented as a basis of discussion before a joint meeting of San Francisco chapter of the California State Society of Certified Public Accountants and the northern California chapter of the Robert Morris Associates.

with and at any point in the cycle which will, within the period of the cycle, become transformed into money.

This definition of current assets squares with the definition of working capital. Generally, there are two kinds of capital—fixed and working. Fixed capital represents the capital invested in so-called fixed properties *with which*, as opposed to *in which*, the enterprise operates. Working capital represents that capital invested or available for investment in those assets which are in a constant state of flux and transformation incident to the operations, those assets *in which*, as opposed to *with which*, an enterprise operates.

You will observe that I approach the subject from its theoretical aspect. I do this with the belief that an understanding of the theories and principles involved with any subject is a necessary preliminary to an enlightened discussion of the practical aspects. If we can determine what should and should not be included in current assets from a purely theoretical point of view, we are then in a better position to increase or decrease group limits to suit it to desirable practice or the requirements of particular purposes. One must know the theory and then have the common sense to know how and to what extent it should be violated. When I stress the theoretical aspect I do not ignore the necessity for that practical application which can only come from mature experience.

I should also like to point out the confusion that often results from indiscriminate and inaccurate use of the terms "liquid assets," "quick assets" and "current assets." Correct usage, I think, should restrict the term "quick assets" to cash and to accounts receivable, securities and similar items which will be, or may be, quickly converted into cash without loss, regardless of a continuance of operations, or, in other words, those assets which are immediately available for the liquidation of current debt. Quick assets do not include those current assets which require a continuance of operation for their realization, while on the other hand quick assets may not be current assets, as would be the case where market securities were held for permanent investment purposes. The term "liquid assets" is, I think, correctly used as the equivalent of "quick assets." Recognizing, however, that all current assets are in a state of flux, or are liquid, the term might easily be used to embrace all and only current assets. I am not attempting, however, an accurate specification of the correct usage, fearing particularly that I might trespass upon some authoritative definition with which I am not familiar.

Having generalized, but still considering the theoretical aspect of the subject, I shall now particularize and define the classes of assets which are embraced by the term "current."

A supply of cash is necessary to the continuance of any trading or operating cycle and its current character should be apparent. In stating that cash is necessary to an operating cycle, I might observe that as it is a bank's business to lend money for the carrying out of commercial operations, and as its paternal instinct is to lend only as the operations require, the maintenance of the cash balance is theoretically unnecessary. But practically it is required as a means of keeping the banker from blushing (if he be not too hardened) when he in fact charges seven per cent. instead of the apparent six.

Trade accounts receivable or trade notes receivable represent merchandise in process of transformation into money and clearly meet the current test, provided, however, that their exchange into money may be expected to occur within the normal period of the operating cycle. In other words, trade accounts or notes which are overdue or contain indication that they will not be currently collected should not, theoretically, be included within current assets. To draw this line too closely, however, would be impractical and confusing, and it seems necessary to exclude only trade accounts and notes whose full collectibility is doubtful or will be too long delayed.

Merchandise represents cash invested in stock in trade as a part of the trading cycle. Its current character is apparent. Similarly, raw materials, whether they be the basic material or incidental supplies requisite for the manufacturing operation or in any way constituting a part of the finished product, naturally fall within the category of current assets. Prepaid expenses, representing money paid in advance for a service to be received which is necessary to the operating cycle, do not differ from a raw material or a manufacturing supply; hence they, too, qualify for admission into the select society of current assets.

Recapitulating, I find the following items should be included as current assets:

Cash.
Trade or service accounts or notes receivable.
Trading merchandise and manufacturing finished product.

Raw materials—The term embracing materials of all sorts which directly or indirectly become a part of the finished product.

Prepayments for services of labor or of property which are essential to the operating or trading cycle.

Let me now review these five items and point out how theory agrees or disagrees with practice in admitting or denying a current classification to particular items.

It is the exception when any portion of cash does not constitute a current asset. Such an exception would occur in a case of funds obtained from the sale of securities or from long term borrowings, for use in capital expenditures, or where a part of the total cash has been earmarked for investment in an insurance-reserve fund, even though there be no legal bar to its employment for the liquidation of any debt. In other words, cash which constitutes a current asset should be restricted to cash which is wholly free for and intended for use in operating purposes. To adopt this theory in practice would admittedly be difficult and would meet much opposition by those who lay great stress on the ability to show a high current ratio regardless of its accuracy. Further, in the absence of an actual appropriation of the amount which is to be used for capital investment or for reserve-fund purposes, it may be impossible to determine accurately what part of the cash will be available for operating purposes and what will not. Consequently, I see no reason to avoid considering all cash as a current asset, in the absence of a definite appropriation for non-operating purposes.

In the case of dividends, bond interest or redemptions and other similar debts due on the day following the balance-sheet date, it might be pertinent to raise a question as to whether such items should not operate to reduce the cash balance, with full showing of the deduction of course, upon the ground that such a part of the total balance represents an accumulation for a particular purpose, for which it is in fact appropriated.

Securities constitute current assets when they represent an investment of surplus cash without intention of reducing working capital. But here we must interject the reservation that they be liquid or quickly realizable. An investment in a non-liquid security is not a current asset because it is not readily realizable. An investment in a liquid security acquired with the *intention* that it be a long term investment, or for a non-operating purpose such as a depletion or an insurance-fund investment, is also not a current asset because the amount is withdrawn from working capital. This is true regardless of its availability, should occasion necessitate, for use in the liquidation of current debt. Here is a case of a quick asset which does not fall within the current classification.

Notes and accounts receivable which do not result from trading or related operations find a place in current assets, upon the theory that they constitute a temporary investment of surplus cash, but such inclusion depend upon the condition that they be currently realizable or, in other words, that they may be collected upon demand or that they will naturally be liquidated within a period not to exceed, in the extreme, twelve months. The objection might be raised that non-current notes and accounts may result only from a desire to lend the credit of the enterprise. That would be the case where the funds to make such loans or advances came directly or indirectly out of bank loans. In such a situation, these assets would have no place whatever in the operating cycle, but as the inclusion of the bank loans as current liabilities, except in particular cases, could not be avoided, the status of working capital and the ratio of the current assets to current liabilities might be seriously impaired unless such assets were admitted into the current category.

Merchandise should call for no discussion, except possibly with respect to its value, and on this point I should like to make one or two mere observations. As Professor Hatfield (I think I am correct in quoting him) has pointed out, there is no theory to support the method of valuing upon the basis of cost or market whichever is lower. Merchandise represents transformed cash, the profit or loss from the trading cycle can not be determined until the cycle has been completed by the transformation of the merchandise back into cash, and, consequently, it should be valued at the amount of cash which has been invested. In other words, merchandise should be valued at cost. But, admittedly, a strict adherence to such a principle would some times be hazardous and in order to be on the safe side it is customary to make a practical concession to the age-old English adage "Cut short your losses, let your profits run."

Questions may be raised as to the propriety of including all operating supplies within the category of current assets, because they are not or at best are only partly realizable, except through the continuance of operation. Such an objection is fallacious, because the same objection in varying lesser degrees can be made against merchandise and raw material. The same objection may be made against prepaid expenses, although frequently, as in insurance, realization is as definite as it is in the case of merchandise, even in the event of a cessation of operations. I believe that prepayments of expenses, at least those which are essential to the operations entering into cost, are as properly included within current assets as are raw materials.

With regard to the inclusion within current assets of supplies and prepaid expenses and the opposing argument founded on their non-availability for the payment of debt, I point out again that current assets can only be considered as fully available for the payment of current debts upon the assumption of a continuance of the business. Continuance of business gradually transforms merchandise, supplies and prepayments into accounts receivable and finally into money with which the debts can be paid. However, the continuance of the business requires the creation of new liabilities for the purchase of more merchandise, so that in a healthy, continuing business current debt is a necessity, and when it bears a proper relation to the current assets it is a sign of health rather than illness. In a business which is concerned with separate and distinct trading cycles, such as that of importing (if it be assumed that each importation will be disposed of prior to the beginning of a new venture), the current debt created in each venture will be wholly liquidated at its end, after which a new venture and a new debt will be created. Ordinarily, however, business is composed of a multiplicity of overlapping ventures and, while not distinguishable, each has its own current assets and its current debt. Accordingly, a continuance of current debt whether it be upon open account or bank loan is to be expected in all cases of continuing growth and expansion.

It is a frequent practice to include within current liabilities redemption payments due within the succeeding twelve months and other similar requirements, although they constitute no theoretical lien against the existing current assets and will, in normal circumstances, be liquidated out of funds to be produced by the operation of the ensuing period. Bond-redemption payments, in particular, are frequently related to depreciation and constitute the equivalent of an actual investment of reserved depreciation. A bond-redemption payment due at the end of a year may and frequently does represent the amount to be realized during the year through depreciation or depletion included as an operating cost. Timber bonds, the redemption payments of which come out of stumpage cut, constitute a particularly clear case. In such and similar instances the inclusion as a current liability of all bond redemption payments due within a year is unwarranted by any theory. It is the equivalent of including as a current liability the indebtedness for a bill of goods and excluding the goods as a current asset. If they must be included, would it not be correct to include as a current asset the amount of depreciation or depletion to be realized during the ensuing year?

There is an inconsistency in the practice of handling certain accruals. If we assume that a certain enterprise pays its rent annually at the end of the calendar year, no objection can be raised to the inclusion as a current liability at June 30th of only the half which has accrued at that time. If the same enterprise has also a bond redemption payment due on December 31st practice requires that the entire amount of the payment be included as a current liability at June 30th and the accountant might be criticized if, consistent with his treatment of accruing rentals, he were to include only one half.

I do not think that liens against future operations, which must be paid under existing contracts within the ensuing twelve months, are, because of that fact alone, properly included within current liabilities. On the other hand, desirable concession to safety and the requirement of providing creditors with full information necessitates that they be so included, although to do so, without provision for including the normally expected realization of non-current assets which will provide the necessary funds, will result in improper impairment of working capital and of the "current ratio." Liabilities which must be paid within the ensuing twelve months do have an important bearing on the probable increase or decrease of working capital during the ensuing period, but matters of policy, with respect to capital expenditures and dividends, have frequently an even greater bearing, yet they are matters which in normal circumstances can not be exhibited in a balance-sheet.

Leaving theory and taking up practice, it is fair to say that the ordinary conception of current assets includes all quick assets, merchandise and all notes and accounts receivable expected to be realized within twelve months. Similarly, the usual conception of current liabilities embraces all existing liabilities requiring liquidation within twelve months. Proceeding upon such a conception, a practice has developed which is not consistent, logical nor fair—in some instances developing an incorrectly favorable current ratio; in others, incorrectly impairing the ratio. It is a practice that will produce wide variations in current ratio between periods: variations which will indicate to the casual observer that the situation of a business has improved, when in fact it has not, or, on the other hand, that the situation has been impaired when in fact it has been improved. If we would be consistent, and if it be desirable that the current ratio have a definite meaning, we should adhere more closely to the theoretical conception of current assets and current liabilities, including as current liabilities only those liabilities which have been caused by current operations or have become a lien upon existing current assets. If we adhere strictly to this theory in the statement of current assets and current liabilities and then add to present balance-sheet classifications a caption which will embrace recorded contractual obligations payable within twelve months out of realization from non-current assets or future profits, we shall be consistent and shall disclose all information with equal if not greater clarity. The suggestion is radical but I present it as a basis for thought and discussion. (Balance-sheets prepared in accord with this and other suggestions are shown hereafter.)

I have only scratched the surface of the subject. I have omitted reference to many debatable items. In particular, I have not spoken of life-insurance surrender value, which has come to be considered a current asset as a concession to popular misconception of its character and in opposition to correct business, as well as accounting, principles. I have hardly touched upon matters of valuation. I have only mentioned the matter of depreciation in relation to bond redemption and to the theory (and it might be defended) that depreciation or depletion to be deducted during the ensuing twelve months constitutes a sort of prepayment which might with propriety be included within current assets. I have not referred to the fact that a proportion of capital expenditures is properly included as a current asset in cases where the enterprise has the right to issue bonds in reimbursement, provided, of course, that there is an open market for such bonds. I think, however, that I have touched upon enough points to permit considerable opportunity for contradiction or at least a discussion of the banker's view as opposed to that of the accountants.

COMPARATIVE BALANCE-SHEETS PREPARED TO ILLUSTRATE THE USUAL PROCEDURE IN COMPARISON WITH A PROCEDURE SUGGESTED IN THE PRECEDING ARTICLE

(A) *Prepared in general accord with usual practice*

ASSETS

Current			$1,000,000
Cash		$ 160,000	
Trade accounts and notes		300,000	
Other notes and accounts		50,000	
Merchandise		350,000	
Finished product	$200,000		
Raw material	150,000		
Securities—marketable (market value $80,000) (a)		100,000	
Life insurance		40,000	
Investments			300,000
Securities—non-marketable		$ 300,000	
Plant properties			550,000
Cost		$ 800,000	
Depreciation reserve (b)		250,000	
Deferred charges to operations (c)			115,000
Operating supplies		$ 25,000	
Prepaid insurance		20,000	
Bond discount and expense		30,000	
Deferred advertising		40,000	
			$1,965,000

LIABILITIES

Current		$ 378,000
Bank notes payable	$ 100,000	
Trade accounts payable	150,000	
Bond interest accrued	10,000	
Bond redemption payment—due in 12 months	60,000	
Income tax	20,000	
Taxes accrued	8,000	
Dividend payable (day following statement date)	30,000	
Funded debt		240,000
First mortgage bonds	$ 300,000	
Less due for redemption in 12 months	60,000	
Capital		1,347,000
Capital stock	$1,000,000	
Surplus	347,000	
		$1,965,000

Notes:

(a) While marketable, these securities are held as an intentionally permanent investment for purposes of income and general protection. Except for marketability they are not different in character or in safety of principle or income from the non-marketable securities.

(b) Depreciation is taken at rate of $70,000 a year.

(c) Here is an illogical combination of prepaid expenses and deferred charges, the first representing a true tangible asset, the second representing only a record of amounts paid for a service already received, from which a continuing benefit may be expected or, as to bond discount, at least a prepaid cost of capital, as opposed to a prepaid operating expense.

(B) *Prepared in accord with suggested procedure*

ASSETS

Current			$ 875,000
Cash		$ 130,000	
Total	$160,000		
Less reserved for dividend	30,000		
Trade accounts and notes		300,000	
Other notes and accounts		50,000	
Merchandise		200,000	
Raw material and operating inventories		195,000	
Raw material	$150,000		
Supplies	25,000		
Prepayments	20,000		
Investments			440,000
Securities		$ 400,000	
Marketable	$100,000		
Non-marketable	300,000		
Life insurance		40,000	
Plant properties			550,000
Cost		$ 800,000	
Depreciation reserve		250,000	
(During ensuing year, approximately $70,000 to be realized from depreciation, and currently contemplated additions amount to $30,000)			
Deferred charges			70,000
Bond discount and expense		$ 30,000	
Deferred advertising		40,000	
			$1,935,000

LIABILITIES

Current		$ 288,000
Bank notes payable	$ 100,000	
Trade accounts payable	150,000	
Income tax	20,000	
Bond interest accrued	10,000	
Taxes accrued	8,000	

Other payments due in ensuing year			$ 60,000
Bond redemption payment		$ 60,000	
Bond interest—$10,000 accrued ......(a)	$ 18,000		
Taxes......... 8,000 " ......(a)	16,000		
Funded debt			240,000
First mortgage bonds		$ 300,000	
Less due for redemption in 12 months		60,000	
Capital			1,347,000
Capital stock		$ 1,000,000	
Surplus		347,000	
			$1,935,000

Note:

(a) There seems to be no requirement for showing of these items in practice.

NOTES ON COMPARISON OF TWO PRECEDING STATEMENTS

Statement A exhibits a current ratio of 2.6%, whereas statement B exhibits a ratio of 3 to 1. It is believed that the second ratio more accurately reflects the relationship between operating assets and liabilities and the current financial situation than the first. Analysis of the various factors indicates that the second is correctly based upon the relative amount of currently borrowed and own capital which is employed in the operations.

The current assets in statement A include $140,000 which are not related to operations and have been included because they are in a position of availability should necessity require, although in ordinary circumstances, such as must be assumed in every statement, there will be no realization from them. On the other hand, $45,000 worth of assets from which normal operations will clearly produce a realization is omitted. In the liabilities there has been included as a current item in (A) $60,000 which is not concerned in any way with the condition resulting from accomplished operations and is a payment due in the future out of proceeds of an ensuing period. If the practice justifying the showing of $1,000,000 of current assets in (A) is based upon a desire to show a measure of ability to pay in an emergency, then still it is not correctly stated, because in an emergency the non-marketable investments would have some substantial quick realizable or collateral value, whereas the raw material at least would suffer considerable depreciation upon an emergency liquidation. On the other hand, in an emergency the $60,000 bond-redemption payment will disappear as a current liability, as the recourse of the creditor will be against the plant properties.

Statement A exhibits net current assets of $622,000 but this amount is not the working capital. Statement B, on the other hand, shows net current assets of $587,000, which analysis will show to be the actual working capital or, in other words, that amount of the proprietary capital which is actually invested in those assets in a continuous state of flux incident to the operations—assets on whose account there is a continuous process of investment and realization. From statement B the following analysis of the apportionment of proprietary capital almost automatically appears, whereas such an analysis is not so clearly suggested by statement A:

Analysis of Apportionment of Total Capital

Invested in:		
Current assets		$ 587,000
Total	$ 875,000	
Less reserved for accruing, but not accrued, liabilities	18,000	
Interest and taxes		
Balance	$ 857,000	
Less accrued and determined liabilities	270,000	
Plant		250,000
Total	$ 550,000	
Less bonded debt	300,000	
Permanent investments		440,000
Being that part of the capital not used in the business but held in reserve against emergency or expansion requirements		
Total		$1,277,000
As shown by statement	$1,347,000	
Less deferred charges recoverable only out of future profits	70,000	1,277,000

While not maintaining that any clear necessity appears for strict adherence to the theoretical, it is submitted that statement B exhibits the situation correctly, whereas statement A does not; that statement A, while showing a greater amount of net current assets, incorrectly impairs the showing of current ratio and that every element which might be desired by a creditor in determining the probable ability of the enterprise to meet its current obligations is exhibited with equal if not greater clarity in statement B than in statement A.

Students' Department

H. P. BAUMANN, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

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

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART I

November 12, 1931, 1:30 P. M. to 6:30 P. M.

The candidate must answer the first three questions and one other question:

No. 1 (30 points):

The trial balance (condensed) of Company A, as at December 31, 1930, was as follows:

	DR.	CR.
Cash	$ 2,438	
Accounts receivable	37,097	
Inventories—January 1, 1930:		
Raw material	7,492	
Jobbing goods	2,564	
Finished goods	10,473	
Machinery and equipment	14,622	
Prepaid insurance	1,300	
Purchases:		
Raw material	88,838	
Jobbing goods	44,045	
Sales:		
Manufactured goods—net		$163,721
Jobbing goods		54,601
Sundry accounts, apart from those detailed, applicable to cost of manufacturing and cost of sales	43,232	
Sundry expense accounts, applicable to profit and loss	51,312	
Notes and accounts payable		24,215
Reserves:		
For depreciation		12,021
For doubtful accounts		3,500
To reduce "Company B's" account to inventory cost value—January 1, 1930		144
Capital stock		18,500
Surplus		26,711
	$303,413	$303,413

Included in the accounts receivable of Company A is an account with "Company B," which is in reality a title only, used by A in selling merchandise on consignment to certain small dealers.

An analysis of this account, as it appears in the accounts-receivable ledger of Company A, is as follows:

	Dr.	Cr.
Balance—January 1, 1930	$ 3,600	
Shipments during 1930	632	
Selling expenses	58	
Cash collections during 1930		$ 2,344
Credit memos. issued in 1930 for goods returned		2,560
	$ 4,290	$ 4,904
		4,290
		$ 614

All cash collected from the customers of "B" is credited to this company's account on the books of A. This procedure has been in vogue for several years.

A list of balances of customers' consignment accounts of "B" totals $1,218 (which is accepted as correct), representing the prices at which the garments are sold to the public by the customers of "B." These customers remit only for garments actually sold and deduct 20 per cent. for their profit. A garment billed to "B" by Company A at the latter's regular selling price of $2 is then sold to the public by the customers of "B" for $2.90. The same proportion holds throughout. Shipments, inventories and sales consist of 75 per cent. of manufactured goods and 25 per cent. of jobbing goods.

On the articles handled by "B," Company A earns a gross profit of 35 per cent. on its selling price on manufactured goods and 25 per cent. on jobbing goods.

A physical inventory of goods on hand at the plant of Company A, at the close of business, December 31, 1930, was as follows:

Raw material	$6,780
Jobbing goods	4,463
Finished goods	7,246

From the foregoing trial balance and following data, prepare
(1) Journal entries necessary to adjust the account of "Company B;"
(2) Statement of cost of goods manufactured and cost of sales;
(3) Statement of profit and loss for the year ended December 31, 1930;
(4) Balance-sheet as at the close of business, December 31, 1930.

Solution:

(1) Journal entries necessary to adjust the account of Company B.

(1)

Reserve to reduce Company B's account to inventory cost value—January 1, 1930	$ 144.00	
Accounts receivable—(B)		$ 144.00

To transfer the reserve account to accounts receivable (B).

(2)

Inventory—manufactured goods—January 1, 1930	2,592.00	
Inventory—jobbing goods—January 1, 1930	864.00	
Accounts receivable—(B)		3,456.00

To set up the inventories of finished goods at January 1, 1930, charged to accounts receivable (B) as follows:

Balance—January 1, 1930	$3,600.00
Less—reserve	144.00
Adjusted balance	$3,456.00

Manufactured goods (75%)	$2,592.00		
Jobbing goods (25%)	864.00		
Total	$3,456.00		

(3)

Sales—manufactured goods		$474.00	
Sales—jobbing goods		$158.00	
Accounts receivable (B)			632.00
To charge the sales accounts with the shipments to Company B as follows:			
Manufactured goods (75%)	$ 474.00		
Jobbing goods (25%)	158.00		
Total	$ 632.00		

(4)

Selling expenses		58.00	
Accounts receivable (B)			58.00
To transfer the charge for selling expenses from the accounts receivable (B).			

(5)

Accounts receivable (B)		2,344.00	
Sales—manufactured goods			1,758.00
Sales—jobbing goods			586.00
To transfer to the sales accounts the sales of Company B.			
Manufactured goods (75%)	$1,758.00		
Jobbing goods (25%)	586.00		
Total	$2,344.00		

(6)

Accounts receivable (B)		2,560.00	
Sales—manufactured goods			1,920.00
Sales—jobbing goods			640.00
To reverse the entry to accounts receivable (B) of credit memoranda issued in 1930 for goods returned.			
Manufactured goods (75%)	$1,920.00		
Jobbing goods (25%)	640.00		
Total	$2,560.00		

Computation of inventory on consignment at December 31, 1930.

The goods billed to Company B include a gross profit on sales of 35 per cent. on the manufactured goods, and 25 per cent. on the jobbing goods.

Company B in turn bills these goods to consignees on the basis of $2.90 for every $2 of cost to it, or at a billed price of 145 per cent. of cost. The consignment customers' accounts represent inventories at cost, plus the two profits noted above.

Consignment customers' accounts at prices billed to customers by Company B		$1,218.00
Cost to Company B is, therefore, $1,218÷145%, or...		$ 840.00
which is made up of:		
Manufactured goods (75%)	$ 630.00	
Jobbing goods (25%)	210.00	840.00
As the cost to Company B includes a profit for manufactured goods of 35% and for jobbing goods of 25%, the		
Cost to Company A is:		
Manufactured goods, as above	$ 630.00	
Less—gross profit of 35%	220.50	
		$ 409.50
Jobbing goods, as above	$ 210.00	
Less—gross profit of 25%	52.50	
		157.50
Total inventory at cost to Company A of goods out on consignment at December 31, 1930		$ 567.00

(2) Company A

Statement of cost of goods manufactured and sold for the year ended December 31, 1930

Particulars	Manufactured goods	Jobbing goods	Total
Inventory—raw materials, January 1, 1930	$ 7,492.00	$	$ 7,492.00
Inventory—jobbing goods, January 1, 1930		3,428.00	3,428.00
Total	$ 7,492.00	$ 3,428.00	$ 10,920.00
Purchases during the year, 1930	88,838.00	44,045.00	132,883.00
Finished goods inventory, January 1, 1930	13,065.00		13,065.00
Sundry accounts, applicable to cost of manufacturing and cost of sales	43,232.00		43,232.00
Total	$152,627.00	$47,473.00	$200,100.00
Deduct—inventories at December 31, 1930:			
Raw materials	$ 6,780.00	$	$ 6,780.00
Finished and jobbing goods	7,655.50	4,620.50	12,276.00
Total deduction	$ 14,435.50	$ 4,620.50	$ 19,056.00
Cost of goods manufactured and sold	$138,191.50	$42,852.50	$181,044.00

(3) Company A

Statement of profit and loss for the year ended December 31, 1930

Particulars	Manufactured goods	Jobbing goods	Total
Sales	$166,925.00	$55,669.00	$222,594.00
Cost of sales (2)	138,191.50	42,852.50	181,044.00
Gross profit on sales	$ 28,733.50	$12,816.50	$ 41,550.00
Sundry expenses applicable to profit and loss			51,370.00
Net loss for the year ended December 31, 1930			$ 9,820.00

(4) Company A

Balance-sheet—December 31, 1930

Assets

Current assets:					
Cash				$ 2,438.00	
Accounts receivable			$ 37,711.00		
Less—reserve for bad debts			3,500.00		
				34,211.00	
Inventories:					
On hand:					
Raw material	$6,780.00				
Jobbing goods	4,463.00				
Finished goods	7,246.00				
		$18,489.00			
On consignment:					
Finished goods	$ 409.50				
Jobbing goods	157.50				
			567.00		
				19,056.00	
					$55,705.00
Machinery and equipment				$14,622.00	
Less—reserve for depreciation				12,021.00	
					2,601.00
Prepaid insurance					1,300.00
					$ 59,606.00

Liabilities and net worth

Current liabilities:			
Notes and accounts payable.........			$ 24,215.00
Net worth:			
Capital stock......................		$18,500.00	
Surplus:			
Balance January 1, 1930..........	$ 26,711.00		
Less—loss for year (3)..........	9,820.00		
		16,891.00	
			35,391.00
			$ 59,606.00

No. 2 (25 points):

Companies M and P are engaged in the exploitation, development and production of minerals. They decide to consolidate and form a Company K with a capital stock of 100,000 shares of no par value.

Under certain rights, acquired for nominal considerations, the holdings of Companies M and P have proved to be very valuable, principally because of discoveries of extensive underground deposits, the cost of which was considerably less than the present intrinsic values.

A disinterested appraisal has been made, and, based upon this appraisal and other assets apart from those appraised, the capital stock of K is to be issued to the stockholders of the subsidiary companies in the following proportions: for each share of M, two shares of K and for each share of P, four shares of K.

The appraisal shows the value of the properties of M to be $2,600,000 and those of P, $4,400,000.

All the stock is exchanged, with the exception of 100 shares of M. Later, 20,000 shares of K stock are sold for cash at $100 a share.

The accounts of M and P, as at the date of consolidation, were as follows:

	M	P
Cash....................................	$ 200,000	$ 100,000
Property..................................	1,600,000	1,800,000
Sundry other assets........................	500,000	100,000
	$2,300,000	$2,000,000
Sundry liabilities..........................	$ 300,000	$ 600,000
Reserves for depletion and depreciation...........	800,000	600,000
Capital stock............................	1,500,000	1,000,000
Surplus (deficit)..........................	300,000	200,000
	$2,300,000	$2,000,000

From the foregoing information

(a) Prepare journal entries to record transactions on books of K.

(b) Prepare a consolidated balance-sheet (in detail) explaining eliminations and adjustments.

(c) Explain basis on which minority interests are computed.

(d) How do you show capital accounts on the consolidated balance-sheet and why?

(e) How do you show property accounts on the consolidated balance-sheet and why?

(f) In preparing a consolidated balance-sheet and income statement as of a subsequent date, what adjustment, if any, would you make with regard to reserves for depletion of mineral deposits?

Solution:

Before the journal entries to record the transactions on the books of Company K can be prepared, it is necessary to consider whether or not the appraised values should be expressed upon the books, and what value should be assigned to the no-par-value stock of Company K. The problem leaves both of these points to the judgment of the candidate. Using the wholly owned subsidiary, Company P, as an example, and assuming a composite rate of 10 per cent. for depreciation and depletion, and that the stock of the subsidiary is $100 par value, let us consider the possible methods of solving the problem.

1. As 20,000 shares of capital stock of Company K were sold for cash at $100 a share, that valuation may be assigned to the 40,000 shares of no-par-value stock of Company K exchanged for the 10,000 shares of stock of Company P. If the appraised values of the property are not expressed upon the books of Company P, we find that the value of the stock of Company K ($4,000,000) is $3,200,000 in excess of the book value of the stock of Company P ($800,000) received in the exchange. Under ordinary circumstances, this excess would be called goodwill. However, as it is shown that the value of the property carried on the books of Company P is understated by $3,200,000 (appraised value, $4,400,000 minus book value, $1,200,000), an adjustment should be made in the consolidated working papers to restate the property valuation and to increase the net worth or book value of the stock of Company P.

But what adjustments for depreciation and depletion, if any, are to be made at a subsequent date? Assume that Company P has a profit at the end of the year of $500,000 before deducting depreciation and depletion of $120,000. The profit of $380,000 would increase the net assets of Company P to $1,180,000. The parent company, K, would take up the profit of $380,000 by a charge to investment account and a credit to surplus. However, in eliminating the investment account against the net worth of Company P, we find:

Investment account on books of Company K......	$4,000,000	
Add—profits for the year........................	380,000	
Total at end of the year........................		$4,380,000
Book value of stock of Company P at the beginning of the year..................................	$ 800,000	
Add—profits for the year........................	380,000	1,180,000
Difference................................		$3,200,000

The excess of the investment account over the book value of the stock of the subsidiary company, considered as an increase in property valuation, rather than as goodwill, has not changed during the year. Obviously, this treatment can not be correct, for if the property account has been increased in the consolidated statement by $3,200,000, some provision for depreciation and depletion should be made on the appreciated values.

2. Let us assume as another choice, that the appraised values were taken up on the books of Company P, by charges of $2,600,000 to the property account, $600,000 to the reserves for depletion and depreciation, and a credit of $3,200,000 to appraisal surplus account. The new book value of the stock of Company

P would be $4,000,000 which would be equal to the balance in the investment account of Company K.

But what adjustments are to be made at the end of the year to account for the depreciation and depletion? Most textbooks would recommend that the realized appreciation be accounted for on the books of Company P as follows:

Profit and loss	$440,000	
Reserves for depreciation and depletion		$440,000
To set up depreciation and depletion on the appraised value of the property at the rate of 10% per annum.		
Profit and loss	60,000	
Surplus		60,000
To transfer the remaining balance in the profit-and-loss account into surplus.		
Appraisal surplus	320,000	
Surplus		320,000
To credit surplus account with the realized appreciation.		

Or as an alternative,

Profit and loss	120,000	
Reserves for depreciation and depletion		120,000
To set up depreciation and depletion at the rate of 10% per annum on the cost (?) of property.		
Profit and loss	380,000	
Surplus		380,000
To transfer the remaining balance in profit-and-loss account into surplus.		
Appraisal surplus	320,000	
Reserves for depreciation and depletion		320,000
To set aside the depreciation and depletion on the excess of appraised values over book value.		

Under this method, the net assets of Company P at the end of the year would be:

Assets:			
Cash and sundry assets		$200,000	
Increase in assets (profit)		500,000	
Property—appraised	$4,400,000		
Less—reserves	440,000	3,960,000	
Total assets			$4,660,000
Liabilities			600,000
Net assets			$4,060,000

But what amount should be taken up by the holding company as profit and as an increase in its investment account? The consolidated profit-and-loss statement should show, in the case of Company P, a profit for the year of

$380,000. If this amount is taken up by Company K, its investment account would show a balance of $4,380,000 which is $320,000 (the amount of the realized appreciation) in excess of the book value of the subsidiary. In preparing the consolidated balance-sheet, the elimination of the investment account against the book value of the subsidiary would leave, each year, a balance increased by the amount of each year's realized appreciation. And this increasing balance certainly can not be considered as goodwill. On the other hand, if the holding company takes up a profit of $60,000 ($500,000 minus $440,000), how will the profit of the operating company ($380,000) be reconciled with the consolidated profit of both companies ($60,000)?

If Company P had sold its assets to Company K for $4,000,000 instead of exchanging its stock, the profits of Company K would appear as $60,000, as the depreciation and depletion of $440,000 would be based upon cost to Company K.

3. As a further choice, let us consider a valuation of the no-par capital stock of Company K based upon the book values without giving any effect to the appraised values whatsoever. The 40,000 shares of stock of Company K would be placed on its books at $800,000, the book value of Company P, or at the rate of $20 a share. It is questionable whether such a valuation was intended, for it seems that a balance-sheet showing a value of $20 a share would not aid in the selling of any unissued stock at a price of $100 a share for cash. Furthermore, there are many who would favor the stating of appraised values on the books, in the circumstances outlined in this problem, as the correct showing of the financial condition of the business.

The profit of Company P, based upon depreciation and depletion of $120,000, would appear in the consolidated profit-and-loss statement at $380,000, and that amount would be taken up by the holding company. No difficulty would be encountered in the preparation of the consolidated balance-sheet, as the book value of Company P of $1,180,000 would be in agreement with the investment account of Company K.

4. In this solution, an attempt is made to avoid the disadvantages noted above, by recording an appraisal surplus on the books of the holding company. The journal entries and working papers are self-explanatory. (c) The minority interest in Company M, represented by the 100 shares of the stock of that company which were not exchanged, is shown in the consolidated balance-sheet in detail. The capital stock is valued at the assumed par value of $100 a share, and the proportionate interest represented by that stock in the deficit and appraisal surplus is set forth. The requirements of sections (d) and (e) regarding the capital and property accounts are discussed above. (f) Under the method used in the solution, the profits of the subsidiaries should be taken up by Company K, by a charge to the investment accounts and a credit to surplus. The depreciation and depletion on the appreciation should be accounted for by a charge to appraisal surplus and a credit to the reserves for depreciation and depletion.

(A) Journal Entries to Record Transactions on the Books of K

Investment in Stock of Company M	$1,800,000	
Investment in Stock of Company P	3,200,000	
Appraisal surplus		$5,000,000

To record on the books of Company K the excess of appraised values over book values of property of Companies M and P.			
Investment in stock of Company M		$1,192,000	
Capital stock—outstanding			$1,192,000
To record the issuance of 29,800 shares of no-par-value capital stock of Company K in exchange for 14,900 shares of capital stock of Company M.			
Net worth of Company M:			
Capital stock	$1,500,000		
Deficit	*300,000*		
Net worth	$1,200,000		
Shares outstanding	15,000		
Book value a share	80		
Investment in stock of Company P		800,000	
Capital stock—outstanding			800,000
To record the issuance of 40,000 shares of no-par-value capital stock of Company K in exchange for 10,000 shares of capital stock of Company P.			
Net worth of Company P:			
Capital stock	$1,000,000		
Deficit	*200,000*		
Net worth	$ 800,000		
Cash		2,000,000	
Capital stock—outstanding			2,000,000
To record the issuance of 20,000 shares of no-par-value capital stock of Company K for cash at $100 a share.			

(B) Company K and Its Subsidiaries, Companies M and P

Consolidated Balance-sheet

Date

Assets

Cash	$2,300,000
Property (as appraised)	7,000,000
Sundry other assets	600,000
Total assets	$9,900,000

COMPANY K AND ITS SUBSIDIARIES, COMPANIES M AND P

Consolidated balance-sheet—working papers

Date

Assets	Companies K	Companies M	Companies P	Adjustments and eliminations Debit	Adjustments and eliminations Credit	Consolidated Balance-Sheet	
Cash	$2,000,000	$ 200,000	$ 100,000			$2,300,000	
Property:							
Company M		1,600,000		$1,800,000 (3)	$ 800,000 (1)	(2,600,000)	
Company P			1,800,000	3,200,000 (4)	600,000 (2)	(4,400,000)	
Sundry other assets		500,000	100,000			600,000	
Investment in stock of Company M—cost	2,992,000				1,800,000 (3)		
Eliminate:							
Capital stock					1,490,000 (A)		
Deficit				*298,000* (A)			
Investment in stock of company P—cost	4,000,000				3,200,000 (4)		
Eliminate:							
Capital stock					1,000,000 (B)		
Deficit				*200,000* (B)			
Total	$8,992,000	$2,300,000	$2,000,000				
Liabilities and net worth							
Sundry liabilities		$ 300,000	$ 600,000				$ 900,000
Reserves for depletion and depreciation:							
Company M		800,000		800,000 (1)			
Company P			600,000	600,000 (2)			
Capital stock:							
Company K—89,800 shares outstanding	$3,992,000						3,992,000
Company M		1,500,000					
Eliminate holding company's interest				1,490,000 (A)			
Minority interest							10,000 (M)
Company P			1,000,000	1,000,000 (B)			
Deficit:							
Company M		*300,000*					
Eliminate holding company's interest					298,000 (A)		
Minority interest							*2,000* (M)
Company P			*200,000*		200,000 (B)		
Appraisal surplus:							
Company M	5,000,000						
Holding company's interest							1,788,000
Minority interest							12,000 (M)
Company P							3,200,000
Total	$8,992,000	$2,300,000	$2,000,000	$9,388,000	$9,388,000	$9,900,000	$9,900,000

Liabilities and Net Worth

Sundry liabilities			$ 900,000
Minority interest in Company M:			
Capital stock	$10,000		
Appraisal surplus	12,000	$ 22,000	
Deduct—Deficit		*2,000*	20,000
Net worth:			
Capital stock—no par value—authorized 100,000 shares—issued and outstanding—89,800 shares		$3,992,000	
Appraisal surplus		4,988,000	8,980,000
Total liabilities and net worth			$9,900,000

Explanations of adjustments and eliminations in working papers.

Numbers one (1) and two (2) record the transfer of the excess of the appraised values over book values of the property of the subsidiaries from the investment accounts to the property accounts.

Numbers three (3) and four (4) write off the reserves for depreciation and depletion carried upon the books of the subsidiaries.

(A) and (B) record the eliminations of the investments in Company M (A) and Company P (B), and the holding company's interest in the book values of those companies.

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.]

QUALIFICATIONS IN PRESENTATION OF FINANCIAL STATEMENTS

Question: I have a problem confronting me which deals with the correct and ethical treatment and presentation of financial statements. If you are in a position to render me an opinion as to your interpretation of the matter, it will be greatly appreciated.

Recently I was called upon to conduct an audit for an investment trust during its first year of corporate existence. To my mind a great many practices of questionable nature were being carried on. However, in conference with the officers and their attorney, who is of the most excellent standing in the community, censure was made of certain proceedings, criticism being spread upon the minutes of the corporation and prohibiting further questionable transactions. After proper action had been taken, a detailed report was rendered by me which set forth the history of activities, and all statements were qualified on the statements themselves. This report was, naturally, of such a character that the officers of the corporation deemed it inadvisable to make a general distribution of it to their stockholders.

Nevertheless, statements have been promised to the stockholders, who number for the most part residents living in the rural section of this part of the state. They have proposed that I prepare a financial statement at the close of July, 1931, for general distribution among their stockholders.

The problem which confronts me is this: Could I prepare a balance-sheet without reference to my prior report, after all activities that border on unethical practices have ceased and since these practices apparently will not be engaged in again? Or, should I qualify or refer on the statement itself to a report rendered under a prior date? Or, could I submit an unqualified statement of condition as at the first of August?

I feel that a great responsibility is vested in me, due, primarily, to the class of stockholders involved. I have discussed the problem with other local practitioners, one thought being advanced that, since it was apparently the desire of the officers of the corporation to conduct an ethical business enterprise and as the activities had not ceased just temporarily for statement purposes, in all probability reference to prior reports and qualifications might cause a great deal more harm than good to the stockholders themselves.

Answer No. 1: We are of the opinion that, if the questionable practices which were being carried on at the time of the first audit have been corrected prior to the second audit and it appears that they will not again be engaged in and the client is acting in entire good faith in the matter, your correspondent should not find it necessary, in certifying the accounts, to refer to prior reports and qualifications, provided the accounts to be certified require no qualification and disclose all pertinent facts. It would appear to us that reference to the prior reports and qualifications in such circumstances would undoubtedly do more harm than good to the stockholders to whom the report would be mailed. If, on the other hand, there is any doubt in the mind of your correspondent that the questionable practices were only temporarily abandoned and will subsequently be revived, he should refuse to certify the accounts and would be well advised to sever his professional connection with the company.

Answer No. 2: Any answer to the query propounded in the letter submitted must, of course, be subject to such changes as a full knowledge of the practices —which are not explained but merely referred to as being "of questionable nature" and "unethical"—might require.

Assuming that these practices do not have an actual bearing on the correct statement of the assets, liabilities and net worth at July 31, 1931, and in view of the fact that "all activities that border on unethical practices have ceased" and that "these practices apparently will not be engaged in again," we would ordinarily see no reason for any reference to such practices in the balance-sheet at that date or in the certificate related thereto. If the practices in question are of such a nature that a statement of the income account for some period ending with the balance-sheet date should properly bring them to light, but no such income account is to be submitted in the proposed report to be published to the stockholders, then, of course, care should be exercised to the end that the reader of the proposed report may not erroneously construe the accountant's certificate as in any way extending beyond the verification of assets, liabilities and net worth as at July 31, 1931, to the point of implying also a certification of the propriety of past transactions which such an income account (were one presented) might reasonably be expected to disclose. The accountant should not merely restrict himself to the preparation and certification of a proper balance-sheet at July 31, 1931, but should go beyond that to see what use was made of it in the proposed report to be published to the stockholders. In other words, the remarks of the president, or other officer, to such stockholders should be submitted to the accountant for approval, to make sure that nothing is implied in such remarks to the stockholders that the accountant might object to as unwarranted by the certificate he has rendered.

Answer No. 3: After a careful reading of the question we are uncertain whether the practices of questionable nature were such as to affect the financial statement at July 31, 1931. If the practices referred to were such that the accountant could not be certain as to the accuracy and integrity of the July 31, 1931, financial statement, there would seem to be no question that a quailfication should be made on the statement or in the certificate.

On the other hand, if the practices which we understand stopped prior to July 31, 1931, did not affect the integrity of the balance-sheet and the accountant is satisfied that the balance-sheet is properly stated, we do not see any necessity for a qualification in the balance-sheet or certificate attached thereto, nor any need for reference to a prior report.

You understand, of course, that without specific information as to the nature of the practices in question it is impossible to render a definite opinion. The foregoing will express our views on the general question, but it is quite possible that a full knowledge of the facts would lead us to change the opinion expressed above.

Current Literature

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Certified Accountants Journal, 50 Bedford Square, London, W. C. 1, England.
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