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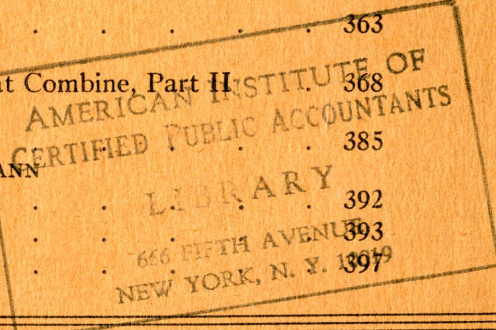
VOLUME LIII

MAY, 1932

NUMBER 5

## CONTENTS

Editorial . . . . .	321
Selection of Auditors — Advantages of Election Seem Great — Comparison of Two Systems — Objections Which Are Not Sound — When the Directors Appoint — Relationship of Auditor and Client — The Financial Strength of France — Some Striking Phrases — Prospects of Recovery — The Waste of Benevolence — The Economic Effect — Comparative Numbers of Unemployed	
Audit Procedure for the Present-day Building-and-Loan Association . . . . .	332
By ROBERT H. MCNAIR . . . . .	
Dividends from Stock Premiums . . . . .	346
By L. L. BRIGGS . . . . .	
Auditor's Responsibility for Inventories . . . . .	354
By T. G. DOUGLAS . . . . .	
Accounting for Waste . . . . .	363
By A. W. MOSER . . . . .	
The Herrings and the First Great Combine, Part II . . . . .	368
By WALTER MUCKLOW . . . . .	
Students' Department . . . . .	385
Edited by H. P. BAUMANN . . . . .	
Book Reviews . . . . .	392
Accounting Questions . . . . .	393
Current Literature . . . . .	397



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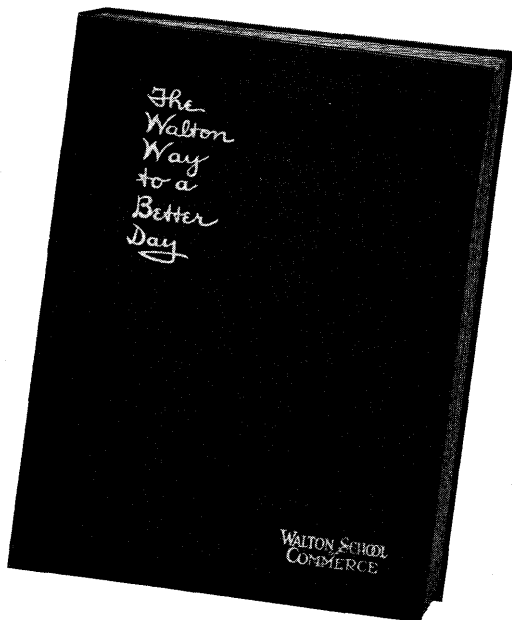
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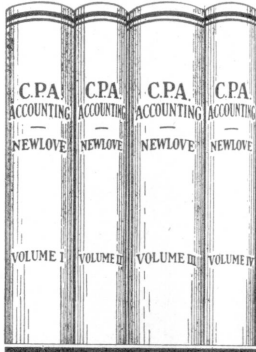
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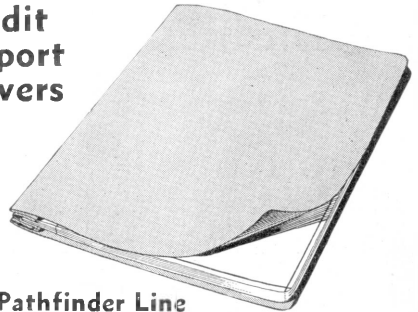
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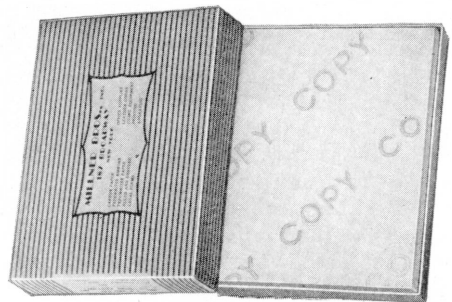
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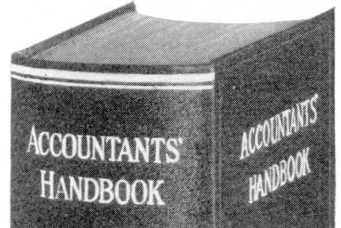
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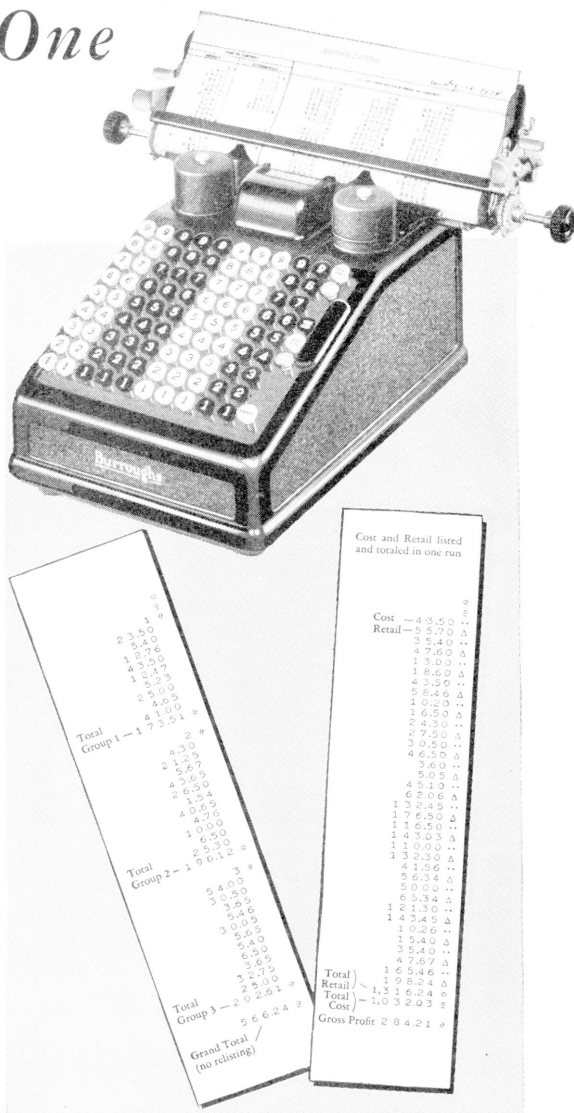
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VOL. 53

MAY, 1932

No. 5

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## EDITORIAL

### Selection of Auditors

We have been requested to discuss briefly the supposed advantages and disadvantages of what may be called the British as opposed to the American method of selection of auditors. This is rather an unfortunate terminology, because what is called the British system is prevalent in many parts of the world where auditors are appointed and what is called the American system does not always prevail in America. It might be better to differentiate the two schemes by calling one the shareholder method and the other the director method. In order to illustrate this much discussed matter there should be a certain amount of background against which the picture may be shown, but there is not space in these pages for a full exposition of the history. Suffice it to say that under the shareholder method, which is perhaps best expressed in the English companies act, the shareholders in annual meeting assembled are required to elect the auditors in the corporation which the shareholders own. Under the other method the directors elected by the shareholders designate the auditor who shall investigate and make a report upon the affairs of the corporation. In the one case, therefore, the true owners select their independent investigator, who might almost be called also an arbiter, and in the other case the directors select one whom they deem competent to perform the same service, but with this marked difference, that they who are merely an elected board of management make the selection of a person or persons who will investigate what they have done and will receive the required fees from them.

**Advantages of Election Seem Great**

At first glance it does not seem that there can be any great difference of opinion as to the relative merits of these plans if one is concerned primarily with an absolutely impartial analysis. It is almost an axiom of modern business that one who investigates anything must be entirely independent of the thing investigated, else his judgment, however honestly given, is in danger of being colored by sympathy or prejudice. The shareholders elect directors to conduct the operations of the business and they expect these directors to render a report to them. They expect the directors to be honest, imbued with a desire to serve the interests of the shareholders and to do everything which the shareholders themselves would do if they had the time and opportunity to direct the conduct of the business. It does seem somewhat preposterous to expect these elected representatives to make through their chosen auditor an impartial report on their own achievements and transactions. On the other hand, if the shareholders select the auditor, he is responsible to them alone, his fees are derived from them and he can have no possible interest, or inclination even, to deal too kindly or too severely with the matters under his consideration. It should be superfluous to say that a reputable accountant is never consciously affected by the identity of his employer. His client is the corporation and it would be utterly reprehensible if he were to think first of the directors and then of the shareholders. Nevertheless, the fact remains that he is necessarily in a more or less confidential relationship to the directors. They have engaged him in his professional capacity. He meets them and reports to them and in all probability the factor of friendship will be present sooner or later. Quite unknowingly, therefore, he must be susceptible to a slightly favorable sentiment for the directors or at least for some of them. He would be more than human if in his report he could forget entirely the personal element, and he would be an exceptional man indeed if the origin of the fee could always be kept out of mind.

**Comparison of Two Systems**

Now let us look for a moment at the advantages and disadvantages of both forms of selection of auditors. It is the custom under what we have called the shareholder form to elect auditors at the annual meeting, and it is generally required, or

at least customary, not to change auditors except for cause. The retiring auditors usually offer themselves for reëlection and it is seldom that there is any competition for appointment. This naturally makes for a continuity of plan and policy and it obviates the danger of an uninformed and unfamiliar scheme of investigation which may or may not be adapted to the particular case. The auditors report directly to the shareholders and if they find that the directors or officers of the corporation have been lax or derelict or that they have been guilty of wrong doing there is nothing in the world to prevent a full report and condemnation by the auditors. The shareholders invariably welcome a blunt statement about the efficiency of the directorate. At the annual meeting it is the custom for the auditors to be present and to answer any question that may be addressed to them by any shareholder. It may be added, parenthetically, that in nine cases out of ten there is a minority shareholder who can ask enough questions to relieve the meeting from any lack of entertainment. The auditors selected in the first place by the shareholders are not apt to be chosen because of personal friendship. The stock of most corporations is fairly well distributed and if there were an attempt to permit friendship to sway the election there would be an uproar from the shareholders who learned of the existence of friendship.

**Objections Which  
Are Not Sound**

The disadvantages of the plan are somewhat imaginary, it seems to us. It is alleged with a great deal of truth that in America shareholders do not take an interest in the management of their company. They are indolent and quite willing to let the directors do it all. They do not even attend meetings. Many corporation meetings are simply formal and no one is present except an assistant secretary, who places the required proxies in a box after they have been counted. What the proxy holders will do has been decided long before the meeting. The minutes are written up and approved and theoretically the shareholders have met. In such circumstances, it is asked, what would be the good of electing auditors by the shareholders? Whoever held the proxies would make the selection, the proxy holders are almost always officers and we should come back therefore to the present system of director appointments under the guise of the shareholder plan. The second objection which is heard is that

the shareholders if they could select their own auditors might do some very strange selecting. Beyond these two points there seems to be no valid objection to the shareholder plan—and these objections may be easily answered. If the shareholders do not take an interest and attend the annual meetings it is largely because they know that they could do nothing effective even if they wanted to do so. The whole thing is cut and dried beforehand. It seems to us that if the shareholders knew that they would have an actual power at their annual meetings there would be abundant attendance and a great deal of interest in all that was done. The very fact that an election of auditors would take place might attract attendance. The second objection, that the shareholders could not be trusted to make a wise selection, is balderdash. It is their company and if they wish to make an unwise choice the result will be on their own heads. There is no law which can require effective wisdom in election, but people who elect generally deserve about what those who are elected give them. This applies in politics as well as in corporate practice. Furthermore there is no reason to believe that shareholders are not competent to select their own auditors. Some of them are remarkably competent.

**When the Directors  
Appoint**

Now the advantages and disadvantages of the director plan are more debatable. It is said in favor of the plan that the auditors should be taken into the confidence of the directors and be in fact but not in name a part of the board of directors. This gives them a constant and intimate association with what is going on and enables them to paint a picture with all the details in mind. It is also alleged, with truth, that when the auditors are selected by the directors they can be engaged or discharged almost at a moment's notice and if their work is not satisfactory other men can be substituted for them. This prevents, in theory at least, the establishment of a bureaucratic and static inefficiency. Then again it is said that from the auditor's point of view the director plan is preferable because the auditor has a visible client, the board of directors, and he may meet each one personally. That, of course, is something that he could not do if every shareholder were his client. It is also argued with a good deal of force that the work of the auditor can never be definitely determined in advance and it may quite easily develop into something much

more comprehensive than was foreseen at the time of appointment or election. If the auditors were elected by the shareholders it would be a more difficult matter to obtain sanction for such a far-reaching investigation than it would be were the directors the clients. In the latter case any change in the plan of audit might be authorized quickly.

**Relationship of Auditor and Client** The last of these positive arguments is probably the most convincing. It is perfectly true that there should be a certain amount of flexibility in the relationship between the accountant and his client, as there should be between the lawyer or architect or engineer and his client, but this flexibility can be secured by action of the shareholders themselves in a resolution granting to the auditor the duty to conduct the usual audit and the permission to do whatever else may seem to him desirable during the course of his association with the corporation. Some one will retort, of course, that such a resolution would place too much latitude before the accountant, but that is to say that the accountant is not trustworthy, and if he is not trustworthy he should not be elected nor appointed. In other words there must be complete confidence in the professional probity of the accountant. The other positive arguments do not carry much weight. There is no reason why there should be close intimacy between the board of directors and the accountant. Indeed in many cases there should be nothing of the kind. The other contention, that a change in the auditorship may be effected rapidly, is not impressive. There have been boards of directors which have felt it necessary to change their auditors because those who had been appointed did not approve the transactions and policies. Many an honest accountant has lost a client because he would not do the wrong thing which the client demanded. To say that the ability to change auditors quickly is desirable is scarcely logical. If the auditor was worthy to be chosen in the first place the probability is that any attempt to dislodge him is due to the unwillingness of the auditor to sacrifice his integrity or good judgment. To sum up, it may be said that it seems to us overwhelmingly desirable to adopt the shareholder plan for the election of auditors. The strictly professional nature of accountancy is demonstrated best in this, that accountants may be trusted to report to those who can not themselves know all that



is going on. Directors, generally, are men of honesty and fair purpose, but some are not, and the truly professional independent investigator, such as the accountant is when elected by the shareholders, is able to render a service to the real owners which may be of enormous value. When he is engaged by the people who are under investigation his personal independence may be jeopardized and the affairs of the corporation itself may not always be given the complete, objective analysis which they should have.

**The Financial  
Strength of  
France**

At a general meeting of stockholders of the Bank of France on January 28th, M. Clement Moret, governor of the bank, presented a remarkable report.

We have not the full text of his statement, but a summary, apparently prepared by the Bank of France, has been translated by the Paris office of the Bankers Trust Company of New York. Based upon the translation of that summary one may reach the conclusion that the financial condition of France, which is generally reflected in the condition of the Bank of France, is astonishingly strong. In a time when all the world is crying out about depression and hard times, it is encouraging to find the governor of one of the great national banks calmly reviewing the whole situation, explaining the causes, as he sees them, of the depression and pointing the road which is leading out into better places. It has always been the history of France that in a time of fiscal crisis some strong man has arisen and has led the nation back to prosperity. Indeed, France seems to have an incorrigible gift for recovery. After the Franco-Prussian war the punitive damages demanded by victorious Germany were considered sufficient to inflict mortal injury upon the paying nation; but, almost before the world had time to analyze the terms of the treaty, France was back on her feet and marching forward. In earlier days, during and after the Napoleonic era, France also evinced her marvelous recuperative powers. Going further back into history one finds crisis after crisis in which all seemed lost and ultimately all was won. Now when the whole world is wallowing in the slough of despond, France, as usual, comes up smiling. There are critics who will say that France's policy has been essentially selfish—but then, what nation is free of the just application of such a charge?

**Some Striking  
Phrases**

Let us quote two or three sentences from the summary, as an indication of the state of affairs in France. According to the translation before us the governor explained in a word what is meant by the gold standard. He said, "In spite of active assistance the Bank of England was forced during the month of September to suspend the convertibility of the pound sterling into gold." That is as clear an exposition of what took place as could be conceived. The whole report should be reprinted, but let us take merely a few sentences here and there.

"In the spring of 1931, the liquidation of the commercial and industrial crisis had begun to make some little headway. As a general thing, wholesale prices seemed to be becoming more stable; the rhythm of production was beginning to adapt itself to diminished purchasing power, but this severe and necessary process of adjustment was far from completion. To bring the crisis to an end the abandonment of those credit abuses which had so largely contributed to its birth and extension would have been necessary. . . .

"The monetary disturbances to which we have just referred have in no way affected the stability of the franc. Due to the fortunate balance of our national economy, and to the wisdom and traditional restraint of the very large majority of our banking institutions, our currency has stood firm and its metallic cover has been even very considerably increased.

". . . Up to the end of the year, when they reached 68,500 millions, our gold reserves have continuously advanced. In one year they have grown by nearly 15 billion francs. . . .

"The solidity of our banking structure made it possible for its members as a whole to withstand successfully these attacks and to get through a particularly difficult period without serious consequences.

"The bank has, moreover, liberally granted its discount privileges to all houses which were in a position to offer the guaranties required by its statutes, and the maintenance of which seemed most necessary to the general economic life of the country.

"We have not hesitated to assume, for the sake of the market, all risks which have seemed consistent with our main desire not to compromise in any way the security of our currency.

"The portfolio, which, from December 24, 1930, to July 10th of last year, declined from nearly 8½ billions to 4,186 millions, increased at the beginning of August following the liberal discount policy and credits granted in the British market. It reached more than 11 billions on October 30th and stood at nearly 8 billions on the last statement of the year. . . .

"The progressive liquidation of artificial monetary systems, which have been in operation since the war, marks, in our opinion,

a decisive step in the road to economic reconstruction. We have always refused to support these facile expedients whose grave risks we realised. We believe it more necessary than ever to maintain the franc's gold cover, which is the only stable basis upon which a currency can rest. We consider convertibility into gold, not as old fashioned bondage, but as a necessary discipline. We see in it the only effective guaranty of the sanctity of contracts and of business morality.

"Determined to guarantee the free play of the gold standard, we desire to stress our firm intention of remaining faithful to this principle, to which the American and French governments have in full accord signified their adherence."

**Prospects of  
Recovery**

No one has ever doubted the inherent financial ability of French financiers, and it is all the more comforting, then, to find that one who, by his position at least, is the leading banker of France today, adheres firmly to the traditional belief in the gold standard. Everyone, of course, admits that the gold standard is not ideally perfect, but on the other hand it has the power of experience behind it. It does serve to measure values throughout the world, and it is certainly infinitely better than any of the wild theories that are enunciated so vehemently by college professors and others who have not the practical history of M. Moret. The whole report is striking in a time of grave loss in values, and it indicates that fundamentally all is still well and before long recognition of that truth must have its effect. To quote again one of the fine phrases which we have printed above, "The rhythm of production is beginning to adapt itself to diminished purchasing power." That is an announcement that the period of fear, which was the great cause of the decline, is passing by.

**The Waste of  
Benevolence**

During the past winter when the whole country was aroused to a spirit of kindness and sympathy for persons who were out of work, a vast amount of temporary employment was provided by the federal government, by states, municipalities and the like and also by private enterprise. Hundreds of thousands of men and women were placed in positions which produced revenue enough to meet the actual requirements for food and shelter. They would not have been over-paid if they had been rendering the service which they were paid to render. But

a rather careful survey of the results of this emergency employment in several different places indicates that the quantity and quality of the work done by temporarily employed people was in almost every case unsatisfactory. The opinion of many of the unemployed who were placed in positions seemed to be that the world owed them a living anyway and, inasmuch as they were not being paid high wages or salaries, the proper thing for them to do was to give nothing in return. Men employed on roads and other public undertakings presented a most disheartening spectacle. It was no uncommon thing to see groups of twenty or thirty reclining gracefully or ungracefully on the handles of shovels and waiting for the hour to pass. A speaker at a recent meeting said that he had made an estimate of the value of work performed by eight men who had been within view of his house for several days and had found that the entire eight had not rendered as much service as one competent workman would have given. This is only an illustration of the conditions which existed probably in most parts of the country. The waste in the aggregate was colossal. One finds it difficult to maintain a sentiment of sympathy for people who have no compunction about taking money for nothing. There is very little difference between taking money out of a cash box and putting it in one's pocket and taking it on a payroll when one renders nothing in return. And yet such is the feeling of a vast army of unemployed that it seems to be an article of faith with them to give as little as possible for what they receive.

**The Economic  
Effect**

There is an economic side of this question which can not be ignored. The money expended on public works, to which were assigned the unemployed, was far in excess in what would have been required in normal conditions. Thus we find a strange anomaly. A country in which there are many people out of work is moved by a spirit of humanitarianism to make employment and to have work done which is not absolutely necessary at the moment, and when the work has been accomplished after a fashion and the cost is computed it is found that altruism is a terribly expensive luxury. Not only is the value of the dollar today far greater than it was, but the actual number of dollars expended on these public and private enterprises for benevolent reasons is out of all proportion to the results obtained. The natural impulse of one who

stops to consider this situation is to refuse further assistance and to let the hungry starve. One is apt to say with much justification that having witnessed the kind of work the out-of-work are able or willing to perform there is small wonder that they are out of work. Of course, on the other hand, it must be argued that many of the men who were attempting to do manual labor had no experience. A man wearing a hard hat, a starched collar and an overcoat, in addition to the ordinary apparel, does not present evidence of fitness for manual work, but there were many men of the other class, men who had been employed where they had to use their hands, and these men were at least equally guilty with the white-collar men. The great majority did absolutely nothing but make gestures which produced no results. Yet the country can not allow its people to want, and so we are brought face to face with one of the most difficult problems of all time. The solution of the problem which Great Britain has adopted is no benefit at all, for it simply induces pauperism. Our method was very little better except that the psychological effect was less injurious. The money paid out in the form of so-called wages was mostly wasted and therefore it is closely analogous to a dole, but it was saved the designation of alms and so perhaps helped to maintain the self-respect of the recipients.

**Comparative Numbers  
of Unemployed**

No one yet has been able to discover the right answer to the question of caring for the unemployed who are necessarily unemployed, but there is a great deal of nonsense written and spoken on the subject of percentage of unemployment. In the rural communities and also in the non-industrial villages and small towns there has probably been very little difference in the ratios of unemployed to employed during recent years. In industrial centres, of course, there has been an abnormal number of men and women out of work, but on the other hand some industries have flourished in spite of the depression and it has been estimated, although no one can know how accurately, that the number of persons wholly unemployed during the past year or more is not quite double the normal number. Against this statement it must be set down that of those who are employed very many are not employed for full time. In order to spread the employment over as many people as possible, companies and others employing labor of all kinds have adopted the

expedient of part time instead of actually discharging any employees. If the ordinary number of unemployed in this country is three million and the average number of totally unemployed during the depression has been six million it is, of course, deplorable, and those who are out of work have suffered acutely, but the country as a whole is not going to the dogs because of such a temporary increase in idleness. Then, again, there are a great many men and women who have regarded with equanimity the compulsory period of rest. There are always people who are willing to yield to the suggestion that they cease from their labors, and so long as there is a little bread and butter in the pantry they will complain about the unemployment but do nothing whatever to avert it. The number of shiftless and thriftless in any community is considerable. Now the point which seems to us of importance is that, in spite of all that has been said about the woe of hard times, the actual want has been far less than one would be led to believe and that in far too many cases the men and women who have been out of work have deserved to be. There are, of course, scores of people who have been glad to take whatever employment was offered and have rendered loyally and faithfully the best that was in them for the wage that was received. It has been inspiring to see now and then a man or woman who was striving earnestly to accomplish the task set, and it is probably safe to say that the demonstration of desire to render an honest day's work given by such people has attracted the attention of potential employers. Those who have worked well will probably find that they have made an opening for themselves somewhere. But the other class, the great army which adopts the slogan, "The world owes me a living and I owe the world nothing," has cost the country and individual enterprises an incalculable sum of money and has done irreparable harm to the morale of the whole population. Every man in the community who is addicted to the habit of accepting without giving lowers the standard of that community, and in times like the recent past people of that sort are much in evidence. We may overlook them during prosperous activity but when there is time to look about and see what is being done these parasites appear magnified.

## Audit Procedure for the Present-day Building-and-Loan Association

BY ROBERT H. McNAIR

As a financial institution offering its services to the investing and borrowing public, the building-and-loan association presents to the public accountant a great opportunity for constructive auditing. This idea of constructive auditing—of bringing to light possible dangers and of making recommendations as to future business policies—although not always received enthusiastically by directors, is nevertheless an important phase of public accounting.

In the original type of association only the members of a community participated, and all made payments during the same period of months. This evolved into what is known as the serial plan, under which new series are begun at intervals and each series is treated separately. Of late years there has been a growing tendency toward the optional-payment plan which resembles the savings account in many respects. The older associations are mutuals. The guaranty or permanent stock association is a relatively new form of organization. The many types of organization make it impossible to present an exhaustive study of the audit procedure within the scope of one article. However, the most important features are presented here, with special emphasis on those accounts which are not encountered in the usual audit programme.

Funds are provided by investing members; these funds are lent to other members on first mortgage security. This is the foundation of the building-and-loan association. The auditing of the members' accounts and the examination of the loan files comprise the leading features of the audit programme. A complete audit necessitates also the calculation of reserves to meet maturities on instalment dues accounts.

The following resources will be considered in the order named:

1. Mortgage loans
2. Delinquent interest
3. Advances to borrowers
4. Loans on stock or certificates
5. Other loans

*Audit of Building-and-Loan Association*

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6. Stocks and bonds
7. Miscellaneous receivables
8. Real estate
9. Furniture and fixtures, automobiles, building
10. Organization expense
11. Cash on hand
12. Cash in banks

The mortgage loan account should be verified by an inspection of the legal papers relative to each loan. The loan register, where one is kept accurately, will serve as a guide in this work. All loan files should be taken charge of or sealed until the inspection is completed. Papers may be checked in and out to the office force as required. The column headings for the mortgage-loan schedule are set forth in form 1. It is sometimes informative to prepare this schedule by towns or to make a summary showing the total lent in each town. Under the column for "type of loan," it may be shown whether the property is residential, commercial, apartments, vacant lot, or other.

The column for "paid in" is important since it shows at a glance the net amount still invested in each loan. By listing the dues paid in on each loan the auditor secures a tie-up between the loans and the dues ledger, thereby ascertaining that each loan is being handled regularly. Otherwise there might be a delinquent loan not showing up as delinquent because no ledger sheet had ever been made out for that member.

In the examination of the loan papers the following points should be given attention:

(a) The mortgage or deed of trust should be inspected for the original amount of the loan, the signature of the borrower and the official seal of the county recorder—this last to make sure that the mortgage has been recorded. It is not within the auditor's duties to examine the county records for a proof that the mortgages have not been released and that there are no prior encumbrances. However, this is an excellent means of obtaining important information concerning any large or unusual loan. I have known of loans on property which had so many prior claims against it that the association's loan was practically unsecured. Although the auditor may not be to blame, he may receive criticism for not informing the stockholders of such a situation.

(b) The note or bond should be examined as to original amount, payments on the principal and signature of the maker. Satis-



factory explanation and proof should be demanded for any dummy notes on file.

(c) The abstract of title will, as a rule, be in the loan file. This is an important document and should be on hand, but ordinarily no further inspection of it is necessary.

(d) The stock certificate, assigned to the association, should be in the file.

(e) Information as to the type of loan or the probable value of the property can usually be obtained from the loan application.

(f) Insurance policies, both fire and tornado, should be on hand for the amount of the loan, or more. There should be a mortgage clause in favor of the association.

Different situations will suggest different subsidiary loan schedules such as:

1. Loans in excess of a certain amount
2. Loans to officers and directors
3. Commercial loans.

A schedule of delinquent loans is important. For this schedule form 2 is suggested. By including advances on this schedule all charges against borrowers, other than the original loan, are shown together. These advances are usually made by the association to pay taxes or insurance on the property mortgaged. Loans that have advances made on them are often among the delinquents. Good management requires that losses from foreclosures be minimized by a continual hammering on delinquent loans. Special mention should be made of loans on which the payments are badly in arrears and those which may result in foreclosure suits, as well as those which are in process of foreclosure at the time of the audit. Ample reserves should be created for bad and doubtful loans. A direct verification of all loans in arrears will serve the double purpose of detecting a possible embezzlement of receipts and of promoting collections on slow accounts.

Loans secured by stock or investment certificates should be verified by an inspection of the notes and the certificates pledged. Care should be taken to ascertain that no loan exceeds the cancellation value of the stock securing it. Interest accrued and unpaid, as well as interest collected in advance, should be set up on the books at the end of each accounting period. Some associations lend money on the dues paid in on mortgage-loan stock. This practice violates the principle of a decreasing equity in the

real estate and should be condemned. Form 3 presents the headings for the schedule of certificate loans.

A building-and-loan association of any size will possibly have a part of its funds invested in loans on other collateral or in stocks and bonds. Frequently serial real-estate notes are taken in payment for real estate sold. The notes, mortgages, abstracts and insurance policies should be examined, and interest accrued or prepaid should be calculated. Special comments may be necessary as to notes past due. A close scrutiny of other collateral and securities owned must be made. Evidence of ownership should be examined and the balance-sheet valuation should be conservative.

There may be miscellaneous receivables, such as advances to agents, employees or officers. These are items of a general nature and need not be discussed here. The auditor should, of course, make note of unusual or excessive advances.

In the course of business most associations find it necessary to acquire real estate by foreclosure. One association, with which I am familiar, boasted of years of existence without a foreclosure. It appeared that when a loan reached the foreclosure state one of the directors of the association would arrange to take over the loan and make the payments. This practice of itself is legitimate but might lead to abuses. A careful analysis of directors' loans will reveal anything of this kind. The book value of real estate owned may properly include the original loan plus additional advances and accrued interest less the cancellation value of the dues paid in. Court costs, subsequent improvements and improvement taxes may be added to the asset value. But expenses such as insurance, general taxes and repairs should not be added to the book value of the real estate, nor should rents collected be deducted therefrom. Hence, it is important that the auditor inspect additions to the real-estate account to determine that they are proper.

Since a building-and-loan association is not in the real-estate business, the management is anxious to turn over its real estate as soon as possible. Often losses are suffered in disposing of property. Ample reserves should be created to absorb these losses. A careful appraisal of each piece of property would provide a basis for the creation of this reserve. Deeds, abstracts and insurance policies should be examined. The deeds should bear the county seal as an evidence that they are on record.

If the association owns furniture and fixtures, an office building, automobiles, etc., these should be conservatively valued. Any additions to these accounts during the year should be supported by voucher. It is a conservative practice sometimes followed by financial institutions to charge off all fixed assets entirely, thereby creating a hidden reserve.

The item of organization expense may appear on the books of a new building-and-loan association, but this debit should be charged off against the profits of the first few years. The appearance of an intangible asset of this nature on the statement of a financial institution is not desirable. If it does appear it should include, of course, only actual expenses of organization.

Cash receipts will usually be deposited daily so that the only cash balance will be the petty-cash fund. This should be counted as near the date of the audit as possible. If collections are not deposited intact, it will be necessary to count the cash and audit receipts and disbursements from the audit date to the date of the cash count. Cash items should be given special attention.

Bank balances will be reconciled and verified direct as in commercial audits. Examining vast numbers of cheques issued to investors for interest, cancellation of stock, etc., is not always of sufficient value to justify the time required. It is true that a building-and-loan association is a cash business and all funds must be accounted for, but if there is a good internal check and if the records are well kept, the auditor should exercise his judgment in the use of his time. The same may be said with regard to checking general-ledger postings. No bank reconciliation is complete without a subsequent verification of all outstanding items.

The resources most often encountered in the audit of a building-and-loan association have been discussed. The following items of liabilities and capital should also be considered:

1. Instalment certificates
2. Fully paid certificates
3. Prepaid certificates
4. Optional-payment accounts
5. Other types of certificates
6. Reserves for earnings
7. Notes payable
8. Miscellaneous payables
9. Accrued interest

10. Interest received in advance
11. Due borrowers
12. Guaranty stock
13. Contingency reserve
14. Surplus

The mutual building-and-loan association obtains its funds from the sale of its capital stock. The guaranty association sells a limited amount of stock and obtains the major portion of its funds from the sale of investment certificates. In the following paragraphs the word "certificate" will be used instead of "stock." Several classes of certificates are in general use.

Instalment certificates are paid for by equal monthly payments. The record of these payments may be kept in a register in which the name of each purchaser is listed, a column being provided for each month's payments. A more modern and convenient system provides for a separate ledger sheet or card for each certificate owner. Each payment is posted to this sheet and the total is brought forward each month. As a proof of these accounts the balances should be added and the total should agree with the controlling account in the general ledger.

A direct verification of these accounts may sometimes be obtained by calling in all passbooks. These would then be checked against the ledger-sheet balances with which they must agree. This method was good for the old type of small community association, but for a large organization, with investors in many localities, the calling in of passbooks is not practicable. Certificate stubs should be checked so as to account for all certificates. Cancelled certificates are often pasted to the corresponding stub. This may be omitted in certain circumstances. Some associations issue no certificates for instalment accounts.

Fully paid certificates are usually sold in multiples of \$100. Interest is paid periodically, often semi-annually, or, if interest coupons are attached, upon presentation of the coupon. The rate depends upon local economic conditions, but 6% is common. An audit of these accounts may be made by checking all certificate stubs and accounting for all certificates. All cancelled certificates should be on file. An excellent test may be made by applying the rate of interest to the average balance of this account and comparing the result with the total of the account for interest on fully paid certificates. This test might disclose any unrecorded certificates issued, the cash for which was pocketed by a

dishonest employee. Individual interest payments should also be test checked. The total certificates outstanding should agree with the controlling account. A schedule of fully paid certificates may or may not be submitted, according to the circumstances.

The designation "prepaid certificate" as used here refers to that type of building-and-loan investment which is paid for in one sum, interest on which is not paid periodically but is allowed to compound until a specified future date when the original deposit plus the interest accumulation is returned to the investor. Certificates should be accounted for and the total tied in with the control, as recommended for the fully paid certificates.

The optional-payment account is a variation of the instalment certificate. Payments may be made at any time and for any amount, and interest is credited periodically. The nature of this type of certificate makes it peculiarly subject to manipulation for the purpose of covering a shortage. This is partly guarded against in organizations whose size justifies a cashier and a book-keeper, but when the books are kept and the cash is handled by the same person, the auditor should do all that lies within his power to verify these accounts. The best verification is effected by the calling of passbooks and checking them against the ledger accounts. This procedure may be impracticable. If it is not done, the audit report should be qualified and the recommendation should be made that a continual audit of these accounts be put into effect—the passbooks to be compared with the ledger accounts by some trusted officer or employee who does not handle the cash. This could be done as passbooks are brought in with deposits. However, this is not as effectual a verification as the other plan. In the absence of a direct verification of optional-payment accounts, the auditor should make a thorough test of credits to individual accounts, tracing the cash so received into the bank account. Debits to these accounts should be tested by inspection of the cancelled cheques. The sum of the balances in these accounts must of course be tied in with the controlling account in the general ledger.

There are variations from these general types of building-and-loan investments, each designed to meet the needs of a certain class of investors. Among these variations are:

1. Insured savings, a combination of building-and-loan and life insurance.

### *Audit of Building-and-Loan Association*

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2. The sinking-fund certificate, an instalment account which matures and is payable not all in one sum but in part each year for a stated number of years.
3. The special prepaid certificate, on which part of the interest is payable periodically and the rest of the interest accumulates to mature the certificate.
4. The teachers' instalment certificate, on which payments are due for nine months only of each year.

The auditing of these accounts presents no problems other than those previously discussed.

The calculation of reserves for accrued earnings on investment certificates is the most technical phase of a building-and-loan audit. These reserves may or may not be calculated by an employee of the association, but in any case the auditor must determine that they are properly set up. Financial statements in which the surplus and reserves are shown as one item are sometimes published. Unless the association distributes the entire profits to the certificate holders, which is rarely done, a statement of this sort does not throw much light on the true condition of the association. It is especially desirable to show these two accounts separately in the case of a guaranty association because the reserves are set aside for the investment certificates and represent a liability, while the free surplus belongs to the guaranty stock.

Accrued earnings may be set up on each individual ledger sheet or they may be calculated and set up in total only. The latter procedure is, I believe, more generally used, since it is not necessary to know the amount earned on any one certificate until maturity. Earnings allowed on cancellations are based upon rates which differ from the maturity rate.

There is no difficulty in calculating accrued interest on fully paid certificates. If this has been paid up to the close of the fiscal year there is no need for a reserve for this item. Prepaid certificate accounts may be classified according to age in months and maturity period. Compound-interest tables giving the amount of \$1.00 for any number of periods at certain rates may be used to calculate the earnings on each group. The age and the rate must be known. If the rate is not known it may be obtained with the use of the table if the number of months required to mature the certificate is known. It may be necessary to interpolate for fractional percentages. The availability of optional-

payment certificates makes it expedient to set up the interest earned on each individual account. The interest is added to the payments on each ledger sheet, and a journal entry is made for the total interest, charging interest expense and crediting optional-payment certificates.

Since fully paid, prepaid and optional-payment certificates as a rule bear definite rates, there is no material difference in the calculations, be it a mutual or a guaranty association. This is not the case, however, with instalment certificates. There are several different methods of calculating reserves for earnings on these. The method to be used depends upon the type of association and upon the policies of the management.

#### I. METHODS OF CALCULATING RESERVES FOR MUTUAL ASSOCIATIONS

(a) *Dexter plan*.—A distribution is made of each year's earnings, after all expenses and transfers to the contingency reserve, on a dollar-month basis. This distribution is final and the effective rate varies from year to year. The stock matures whenever the annual additions to the payments reach the par value.

(b) *Partnership plan*.—The distributable earnings for the current year are added to the reserve brought forward from prior years and the total is allocated to all instalment stock on a dollar-month basis; thus the earnings over a period of years are equalized. This method is preferred over the Dexter plan because the maturity periods thus become stabilized so that the investor may be reasonably certain as to the maturity date of his certificate. By this method all stock is classified and grouped according to series and certain information is set down as shown in form 5. The rate of earnings per dollar-month is obtained by dividing the total reserve available by the total dollar-months (column 10 of form 5). The rate thus obtained is then applied to the dollar-months of each series, and the result is the earnings of the respective series.

(c) A plan often adopted by the board of directors of a mutual association provides that each class of stock have a definite maturity period. Reserves for earnings are set up on that basis and any excess or deficiency is handled through a surplus or undivided-profits account. This excess, of course, belongs to the instalment stock but is not appropriated. It is used to improve the reserve strength of the association. This arbitrary maturity period should be ample so that the earnings thus distributed will

not exceed the available reserves. Unusual circumstances may necessitate the extension of the maturity period.

Assuming that payments are due the first of the month the formula to be used to obtain the rate per dollar-month under this plan is:

$$\frac{\frac{E}{\frac{P+1}{2} \times D}}$$

where  $E$  represents the earnings,  $P$  the maturity period and  $D$  the total dues payments.

As an example let us say that a monthly payment of \$10 is required for 78 consecutive months to mature \$1,000. Then the total of dues paid in is \$780 ( $78 \times \$10$ ); the earnings are \$220 ( $\$1,000 - \$780$ ), and the period is 78 months. Substituting in the formula above, we have

$$\frac{220}{\frac{78+1}{2} \times 780} = \frac{220}{39.5 \times 780} = \frac{220}{30,810}$$

= .0071405, the monthly rate to be used in obtaining column 11, form 5. The annual rate in this case is  $12 \times .0071405$  or 8.5686% simple interest. When this plan is adopted the maturity periods of the different classes of stock should be fixed so as to allow very nearly the same rate of earnings on all classes.

## II. METHODS OF CALCULATING RESERVES FOR GUARANTY ASSOCIATIONS

(a) Guaranty associations usually pay a definite rate of compound interest to instalment investors. In this case a compound-interest table may be applied either to each account or to each series, according to the instalment plan of the individual association.

(b) In case a membership fee is charged and taken out of the first payments, the true rate will be slightly higher than the stated rate in order to absorb the membership fee during the life of the contract. In some cases fractional rates must be calculated and special tables constructed for use in calculating reserves.

The practice of setting up reserves on a cancellation basis is not conservative and is to be condemned. Reserves set up on a



maturity basis are probably higher than will be required, because many certificates will be cancelled before maturity and thus will receive less interest than has been provided in the reserve. This, however, does not justify the use of a cancellation basis for the reserve. Experience tables of the percentage of persistency for each class of instalment account may some day be available and enable one to reach a closer estimate of required reserves, but until that time the maturity basis should be used.

Other liabilities of a building-and-loan association may include notes payable, which should be verified direct as to amount, due date and accrued interest. Sundry accounts payable for current expenses and accrued items should be set up. Accrued interest payable and interest received in advance should appear on the liability side of the financial statement.

There sometimes appears an account entitled "due borrowers, unfinished loans or construction loans," which represents balances, secured by mortgages, which have not yet been paid out to the borrowers. It is customary to show this on the liability side of the balance-sheet, but it is preferable to show it as a deduction from the mortgage-loan account, the balance representing money actually paid out on mortgages. The unfinished-loans account is sometimes used as a means of inflating the financial statement by crediting to it all loans applied for and pending, whether the loans have been approved and the papers drawn up or not. This practice will be detected during the inspection of loan papers. No loans should be set up as assets on the one side and as due borrowers on the other, unless the mortgage has been signed and recorded and unless the loan is bona fide.

The net-worth section of the balance-sheet of a guaranty building-and-loan association includes guaranty or permanent capital stock, surplus, contingency reserve and other capital reserves.

Guaranty stock may be similar to any of the forms of investment certificate, but differs from them in that it is not withdrawable but serves as a permanent working fund and as a protection to other investors. All stock certificates should be accounted for, a schedule should be built and the total should be balanced with the control account. Special care should be taken to see that none of this stock has been redeemed by the association and that no loans have been made with guaranty stock as security. This would be contrary to the purpose for which it is issued and is in most cases illegal. In some states there is a minimum require-

ment to be paid in on guaranty stock. The auditor must see that this requirement is met. Dividends on guaranty stock may be paid or credited only after all other requirements have been provided.

Any surplus from special sources or appropriated for specific purposes should be so labelled. Contingency reserve is composed of annual increments provided from current profits. Unusual losses on loans, real estate, etc., may be charged against this reserve. The auditor should ascertain that legal requirements have been met as to the yearly addition and the balance maintained in this reserve.

In auditing the income and expense for the year sufficient test checking should be done to satisfy the auditor as to the general accuracy of these accounts. The principal source of income is interest. It is sometimes possible to make an effective proof of the interest by applying the average rate to the average loan balance. Tests should be made by checking the interest credits on the individual ledgers back to the cashbook. Other items of income are membership or withdrawal fees, transfer fees, fines and rents.

Expense items may usually be classified as administrative, selling and collection or general. Under administrative expense there will be executive salaries, office salaries, office supplies, telephone and telegraph, postage, office rent, heat, light and water and the usual other administrative expenses. An analysis of salaries is important.

Salesmen's salaries, commissions, salesmen's travel, automobile, advertising, etc., will be classified as selling and collecting expense. The usual general-expense items are interest, taxes, expense on real estate owned and similar items. Interest in most cases will be the largest expense item. In a mutual association the interest account will be replaced by an account for dividends. The dividend account of course is not an expense but will be deducted direct from surplus. Expense accounts should be audited much as in a commercial audit. The detail work to be done depends upon the size of the association and other conditions.

Little mention has been made of the routine work required in the course of a building-and-loan audit. Specific conditions will call for varying degrees of detailed checking. It may or may not be advisable to check all the general-ledger postings. A fairly thorough test of the addition of the cashbook is considered im-

portant. Building-and-loan shortages have been uncovered by this precaution.

The text of the audit report should set forth the extent of the audit, the auditor's qualifications to his statements and items which deserve special attention. The arrangement of the balance-sheet is optional but the preferred form sets forth mortgage loans first, followed by other types of loans, advances and accrued interest; then real estate and other assets; and finally cash. The liabilities may be arranged in the following order: all certificate accounts, followed by certificate reserves, then due borrowers and other liabilities—and last, permanent stock, surplus, reserve for contingencies and other capital reserves. It is of interest to show the total loans of all kinds, the total liability on certificates and the total permanent stock and capital reserves on the balance-sheet.

The auditor's responsibilities regarding legal requirements must not be overlooked. State laws differ; the auditor must familiarize himself with the statutes governing the building-and-loan association which he is examining. State laws often include the following regulations:

1. Minimum permanent stock required to be paid in for guaranty associations.
2. Permanent stock dividends allowed only after all other interest is provided.
3. Permanent stock, non-withdrawable; no loans may be made on permanent stock as collateral.
4. Part withdrawal or checking against optional payment certificates prohibited.
5. Associations borrowing power limited to a certain percentage of assets; maximum period for which a loan may be made.
6. Second mortgage loans prohibited.
7. Loans to any one person limited to a certain percentage of the assets.
8. Limitations on loans to officers and directors.
9. Regulations on securities owned.
10. Surety bonds on officers required.
11. Maximum rates of withdrawal fees allowed.
12. Requirements as to reserve for contingencies:
  - (a) A certain percentage of net earnings each year to be transferred to contingency reserve.
  - (b) Reserve must be maintained at a certain percentage of assets.
13. Real estate must not be held for longer than a stated period.

*Audit of Building-and-Loan Association*

14. Expenses limited to a percentage of loans.
15. Liability of directors for dividends paid in excess of available surplus.

It should be seen that statutes are obeyed. The minutes of directors' meetings should be reviewed for any light they may throw on officers' remuneration, contingent liabilities and general business policies.

FORM 1. MORTGAGE LOAN SCHEDULE

LOAN NO.	DATE OF LOAN	BORROWER	TYPE OF LOAN	AMOUNT OF LOAN	NET DUES PAID IN	ASSN'S EQUITY	INSURANCE CARRIED	LOAN PAPERS MISSING	REMARKS

FORM 2 DELINQUENT LOAN SCHEDULE

LOAN NO.	BORROWER	NO. MONTHS DELINQUENT	DELINQUENT DUES	DELINQUENT INTEREST	ADVANCES PAID BORROWERS	ACCRUED FINES	TOTAL	REMARKS

FORM 3. CERTIFICATE LOAN SCHEDULE

LOAN NO.	DATE	DATE DUE	BORROWER	AMOUNT OF LOAN	STOCK CASH VALUE	AMOUNT REQUIRED	ACCRUED INTEREST	REMARKS

FORM 4 REAL ESTATE SCHEDULE

FORMER OWNER	DESCRIPTION	DATE ACQUIRED	ORIGINAL COST	ADDITIONAL COSTS	BOOK VALUE	APPRAISED VALUE	RESERVE	MONTHLY RENTAL	REMARKS

FORM 5. AGE AND CONDITION OF SHARES

CLASS AND SERIES	DATE OF ISSUE	AGE IN MONTHS	NO. OF SHARES	MONTHLY PAYMENT	DUES RE-QUIREMENT	ADVANCE PAYMENT	DELINQUENT PAYMENTS	NET DUES	DOLLAR MONTHS	EARNINGS PER SERIES	DUES PER \$1000.00	EARNINGS PER \$1000.00	VALUE PER \$1000.00

\* COLUMN (3) X COLUMN (5)  
 \*\* COLUMN (6) + COLUMN (7) - COLUMN (8)  
 \*\*\* (COLUMN (9) + 1) ÷ 2 X COLUMN (6)  
 \*\*\*\* COLUMN (10) X RATE PER DOLLAR MONTH

## Dividends from Stock Premiums

BY L. L. BRIGGS

If purchasers of capital stock in a corporation pay more than par value for the shares, the question may arise as to the availability of this premium for dividend purposes. The purpose of this article is to state the main facts of the leading court decisions directly or indirectly involving the payment of dividends from such paid-in surplus.

Most accountants consider stock premium to be a special surplus in the nature of a capital contribution which is unavailable for distribution to stockholders in the form of dividends. Sir Arthur Lowes Dickinson, the eminent English accountant, admits that it is surplus, but he insists that premium on stock is not profit on operations and should not be credited to income (*Accounting Practice and Procedure*, p. 128). Accountants agree that if such paid-in surplus is paid to stockholders they should not be led to believe that the distribution is a part of the current profits.

The rules of the interstate commerce commission state that premiums received upon the stock of railroads are not to be credited to income but to a special account. However, provision is made for the accounting when a railroad is permitted and elects to distribute the premiums to its stockholders.

The general corporation laws ignore the availability of capital-stock premiums for dividends. However the statutes of Louisiana specify that corporate directors must notify stockholders of the source of the distribution when a cash dividend is made from paid-in surplus, and Ohio makes the same requirement when dividends are from any source other than earned surplus.

The German statutes provide that premium on capital stock is not a part of ordinary profits and must be credited to a special surplus account instead of profit and loss.

So far as I am aware, the only English decision touching upon the availability of stock premiums for dividends is *In re Hoare and Company* (1904) 2 Ch. 208. According to the facts of this case, Hoare & Co. had built up a reserve composed partly of premiums received for leases, partly of premiums received on the issue of preference shares and partly of ordinary business profits. The concern had sustained a loss arising from depreciation of its

## *Dividends from Stock Premiums*

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public-houses below the amount stated in the balance-sheet, and it asked the court to allow a reduction in part of the capital stock and in part of the reserve of an amount equal to this loss. In giving the decision granting the request, Lord Justice Romer said:

“In other words, the surplus which was carried to the reserve fund represented that which might have been properly applied at the time, if the company had so thought fit, in paying further dividends to the stockholders, and no person could have complained if they had done so.”

In the same decision, Lord Justice Vaughn Williams made the following statement:

“Supposing, for instance, there had been no scheme for reduction at all, what could the company have done? Could they have distributed this sum as a dividend? Theoretically, I think they could.”

The reader should bear in mind, however, that the legal principle under consideration in this case is whether or not both capital stock and reserves may be reduced to offset a capital loss, so the above quotations are dicta and may have no authority as law in regard to stock premiums.

*Union Pacific v. Ferguson* (1913) 64 Or. 395, is often cited as authority for the rule that premium on capital stock may be distributed to shareholders as dividends. Let us consider the facts of this case. The Oregon statute provides that no insurance corporation can transact business until it has a paid-up capital of \$100,000. The Union Pacific Life Insurance Company sold 7,541 shares of its capital stock for \$100,000 and claimed that this complied with the provision of the statute. Justice Eakin said:

“This \$100,000, mentioned in the statute, must be the trust fund that can not be withdrawn or in any manner diverted by the corporation. It is the fund with which the corporation transacts its business and stands as security to the stockholders. It does not include profits or surplus until they have been made capital in some legal way.”

The court held that the requirements of the statute were not satisfied because \$24,590 of the selling price represented premium on stock which is profit on the sale of stock and is subject to withdrawal at any time.

If a corporation with a surplus sells additional stock at the book value of the old, it seems reasonable to credit the premium to surplus so that the amount available for dividends on the original shares will not be diminished. Ignatius, on page 74 of his *Financing of Public Service Corporations*, says:

“The generally accepted theory is that the premiums represent a payment by the purchasers of the stock for the privilege of acquiring a new or added

interest. If this theory be given its logical effect, the premium will accrue to the favor of the existing stockholders, among whom it could be distributed as a special dividend, and there will be no reason for carrying the amount as a permanent reserve. The reason why a premium is paid is either that the value of the proportionate interest of the shares in the corporate assets exceeds their par value or else the assurance of earnings is such as to assign a high investment value to the shares. In the final analysis the last reason becomes merged with the first, for in most cases the value of the corporate assets as a whole is predicated upon earning power. Under these circumstances the premium is collected on the new shares to equalize the interests of the old and new stockholders. Let us assume that the old stockholders paid par, and thereafter put back enough earnings in the plant to give the stock a certain value above par; the new stockholders pay par also, and in addition an amount approximating the amount of earnings not taken out by the old stockholders. The two sets of stockholders are thus put upon an equal footing; they could turn around and divide the corporate assets above the par of the total capital stock with absolute equity to both the old and the new stockholders."

It has been held that premium on stock issued is not income for the purposes of the federal income tax (*Boston and Maine Railway v. United States* (1920) 265 Fed. 578). In *New York v. United States* (1920) 269 Fed. 907, Circuit Judge Manton held that paid-up capital stock under the federal income-tax law does not include stock premiums. According to the court:

"The excess paid in price is, in fact, a premium paid for the stock; for when such shares of stock are at face value, they are at par, and when more is paid, they are above par or at a premium. The total of the par value has always been considered capital stock. The term 'capital stock' has thus been used not only in banking and commerce, but in the corporation acts of the several states. Full force and effect must be given to the term 'paid-up' as used in the statute, and its use in connection with 'not exceeding.' We think that the employment of those words made the intention of congress clear as obviously meaning paid up to par value, and not exceeding that. The premiums received were used, in carrying on the business of the corporation, as if surplus. . . ."

*Ohio v. Franklin Bank of Columbus* (1840) 10 Ohio 91, is a taxation case which incidentally involves the status of stock premiums. The Franklin Bank of Columbus sold new stock at a premium of \$10,160, which was paid to the old stockholders in proportion to their holdings at the time of the sale. The bank paid a tax of \$508 on this distribution, under a law taxing dividends from bank profits, and later brought an action against the state to recover the tax paid on the ground that stock premium is not profit. In giving the decision in favor of the bank, Justice Hitchcock said:

"This premium was not divided as ordinary profits but distributed among those who had been stockholders at the time the capital was increased, and was in effect the same as a price paid to them by those who purchased the new stock, for the privilege of coming into, what was considered to be, a profitable concern."

Apparently the court did not favor adding the premium to surplus for it made the following comment:

“If this stock is above par in the market, it is the gain of the stockholder, and not of the corporation. If it is below par it is the loss of the stockholder. The value of the stock, it is true, will depend upon the condition of the corporation, but the corporation so far as its own property is concerned is not affected by that value.”

According to the facts of *Miller v. Payne* (1912) 150 Wis. 354, the trustees of an estate held shares of capital stock of the First National Bank of Milwaukee. The question before the court was whether or not dividends had been declared from earnings since February 5, 1906. On May 15, 1911, the bank declared a dividend which was larger than the earnings between that date and February 5, 1906. However, between these dates the institution had sold \$500,000 par value stock at 170 at a time when the book value of the \$2,000,000 par of old stock was \$153.50 a share. The court reasoned that it would take 53½% of \$500,000, or \$267,500 of the \$350,000 premium, to place the new stockholders on a parity of investment with the old. After the book values of both classes of stockholders were equalized, the \$82,500 balance of the premium was a profit and might be proportionately divided between the old shareholders and the new. Since the old shareholders held four-fifths of the stock they were entitled to four-fifths of the profit of \$82,500 or \$66,000. This amount added to the earnings from the business over the period in question made a total which was larger than the amount of dividends declared on May 15, 1911. Therefore, this dividend was from earnings. In the decision, Justice Vinje said:

“The distribution of the premium made on the sale of the new stock is an equitable and just one. Fifty-three-and-five-tenths per cent. of that went to make the book value of the new stock equal the old. The difference between that and 170 per cent. at which the new stock sold, represented a net profit to be distributed ratably between old and new stock.”

The decision implies that the \$267,500 was available for dividends, although the court made no definite statement to that effect.

*Smith v. Cotting* (1918) 231 Mass. 42, among other things, incidentally involves the status of an extra cash dividend payable from surplus derived from premiums on capital stock. The stock was sold at various times at several different prices and there was no evidence that premiums were received on all the shares. Part of the premiums was directly credited to surplus while the rest reached the same account by way of profit and loss. The total amount of the premiums was more than sufficient to meet the



requirements of the dividend. The main issue in the case was whether this dividend was capital or income. The court decided that it was income. Justice Braley said:

"Whatever might be said as to premiums paid on shares originally issued, it is obvious, that the very large premiums received by the corporation on some subsequent issues were paid not as capital, but for the right to share in the profits, surplus and other earnings which had been accumulated and remained undistributed. . . . We find nothing which would have prevented the corporation by appropriate votes from using this surplus, profit and loss, undivided profits, or however the premiums may be designated, for any legitimate purpose. Not having been segregated as capital it could be appropriated for the payment of dividends. . . ."

The court added:

"If by reason of the apparent prospect of great financial success the corporation not only at its inception but subsequently was enabled to sell its stock for more than par, the money obtained . . . was not an accretion of the fundamental capital, which could be increased only in the manner provided by statute. It represents a portion only of treasury assets in the nature of gains, or profits, which the corporation could distribute without reducing the value of its remaining property below the par value of the entire capital stock including the proposed increase, or impairing its resources which remained amply sufficient for the satisfaction of all indebtedness."

In *Equitable Life Assurance v. Union Pacific* (1914) 212 N. Y. 360, the plaintiff, a large holder of Union Pacific preferred stock, initiated an action to restrain the distribution of an \$80,000,000 dividend to the common stockholders. Part of this amount came from the retirement of convertible bonds at the rate of one share of stock for \$175 in par value of bonds, which gave a premium of \$75 on each share of stock. The plaintiff claimed that this premium was an increase of capital which should be distributed to both the common and the preferred stockholders. As the court allowed the payment of the dividend it apparently thought that the premium was not an increment of capital but was an ordinary distributable profit. In the decision, Justice Hiscock made this statement:

"The extra \$75 paid per share represented the amount of accumulated profits or surplus which it was supposed would be apportionable to each share after payment and issue. In other words, as I think we must assume, the payment of this premium was not for permanent capital, but for the purpose of equalizing as between new and old stockholders their respective rights in accumulated profits, which, so far as we know, were current and distributable in dividends. When paid in, this premium became part of such accumulation of profits and surplus and distributable as such. It was credited to the profit-and-loss account, and not to capital."

Justice Hiscock also said:

"The proposition that these profits because resulting from what was perhaps an unusual transaction are not profits, but an accretion which 'belongs to capital,' notwithstanding the painstaking argument of counsel, does not seem to have any foundation on which to rest except earnest assertion."

The court distinguished this class of stock premium from that paid on stock at incorporation but gave no opinion as to the status of the latter.

The distribution of stock premiums to stockholders may be regarded as a capital return instead of a dividend. Since there is no rule against capital contributions greater than the par value of the stock sold there should be no objection if the excess is returned to the contributors. In other words, if the stock purchasers wish to pay more than par for their stock it may not be fair to require them permanently to invest the extra amount.

*People v. Knight* (1904) 89 N. Y. S. 72, is a case in which the stockholders paid \$500,000 into the treasury of the corporation for working capital, for which no extra additional stock was issued, and this amount was virtually a stock premium so far as the corporation and the stockholders were concerned. Later, to facilitate the carrying out of a merger, \$200,000 was returned to the stockholders of this corporation in order to equalize the holdings of the two groups of stockholders. In the decision in which the court held that this distribution was not a dividend for tax purposes, Justice Chester made this statement:

“It seems to me clear that the \$200,000 so returned can not fairly be regarded as from the ‘surplus profits’ of the company, for it did not in any sense arise from its profits or earnings in the course of its business, but was contributed solely for the purpose of strengthening the company and adding to its working capital. That being so, it was not a dividend, within the meaning of the law.”

In *People v. Travis* (1916) 157 N. Y. S. 943, the court reached the same conclusion. Presiding Justice Kellogg said that:

“A corporation may begin business with a surplus contributed by its stockholders, and may thereafter divide that surplus, and such division is treated as a distribution of original capital and not as a dividend. In such a case the stockholders are only withdrawing from the company the moneys which they paid to it for temporary use, over and above the capital stock.”

*Merchants' and Insurers' Reporting Company v. Youtz* (1918) 178 Pac. 540, is a California decision which apparently holds that stock premiums are capital which must be retained by the corporation for the benefit of creditors and, consequently, are not available for distribution to stockholders as dividends. The plaintiff company sold capital stock at a premium of \$28,169.17 and credited this amount to the profit-and-loss account. Evidence showed that there had been no net profit from operations. The plaintiff charged that in spite of this Youtz and other members of the board of directors declared and paid dividends amount-

ing to \$34,000 in violation of the California civil code, which provides that dividends must come from profits. The plaintiff brought this action to recover the amount of the dividends from the defendants. In giving the decision for the plaintiff, Presiding Justice Conrey said:

"Without further details of items shown, suffice it to say that the corporation never had any surplus profits out of which dividends could have been paid, unless the moneys received as 'premiums' above the par value of the stock sold might be segregated from the assets of the corporation and treated as profits of its business. We are satisfied that the entire proceeds of sales by a corporation of its own stock, even when sold for more than par value, are part of its original assets or capital stock and therefore can not be profits earned through the conduct of its business. The phrase 'capital stock,' as used in section 309 of the civil code, means 'not the shares with which the nominal capital is composed, but the actual capital; i.e., assets, with which the corporation carries on its corporate business.' . . . The sole purpose of selling stock is to acquire assets with which to carry on that business. This is equally true, whether the stock be sold at par, or below par, or above par. The capital stock referred to in said section 309 'is the actual property of the corporation contributed by the shareholders.' . . . It is, in brief, the 'capital of the corporation.'"

*Corliss v. United States* (1925) 7 Fed. (2d) 455, is a case in which a creamery company rapidly expanded operations and increased its capital stock from \$164,000 in 1917 to \$3,000,000 in 1920. In a prosecution of the concern by the federal government, it was shown that the company promised that it would pay 11% dividends and would return the purchase price of the stock to any buyer who became dissatisfied. During the period when this stock was sold the company operated at a loss and the dividends paid in 1918 were from funds arising from capital stock premiums. Although the company was not held criminally liable, District Judge Amidon said:

"As a general rule, corporations have no right to pay dividends out of any fund except the excess remaining from the conduct of the business after paying taxes, operating expenses, and fixed charges."

However, the court admitted that this rule is not universally followed and cited *Smith v. Cotting* (supra) as authority for the legality of dividends from premiums on capital stock.

It is interesting to note that eminent legal writers do not agree upon the dividend status of capital-stock premiums. In 37 *Harvard Law Review* 475, C. W. Wickersham suggests that if more than par value is received from the sale of capital stock the premium constitutes capital, while Attorney-General W. D. Mitchell, in 11 *American Bar Association Journal* 380, disagrees with this suggestion and concludes that surplus should be available for dividends regardless of its source.

### *Dividends from Stock Premiums*

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A brief summary is now in order. Although many leading accountants agree that premiums on capital stock are not available for dividends, the general corporation statutes give little or no light on the subject and the court decisions touching the point are not only scarce but conflicting and inconclusive. Most of the cases which have been quoted contain mere dicta, which may show a tendency on the part of the courts but may not be authoritative as law, while the rest of the cases have decisions based upon the interpretation of a particular statute or contract. It seems to me that this phase of corporation law is still in the process of development, and that it is extremely difficult at the present time to determine which way the weight of authority inclines. However, it is hoped that the courts eventually will set their approval upon what accountants consider to be conservative practice, that is, the prohibition of dividends from capital-stock premiums unless the stockholders are informed of the source of such distributions.

## Auditor's Responsibility for Inventories

BY T. G. DOUGLAS

There appear to be increasing growth and insistence in the demand of commercial bankers for the assumption by public accountants of complete responsibility with respect to the item of inventories appearing on audited balance-sheets used for credit purposes. It is believed that this demand has resulted to a large extent from failure on the part of public accountants to make clear to bankers these two important facts:

That practical obstacles render it impossible, except in rare instances, for the public accountant to take or supervise the physical inventories of his clients and thus assume that complete responsibility.

That in every properly conducted audit steps are taken to verify, by every means available, the substantial accuracy of the quantities shown by the inventories and the fact that the commodities are salable or usable, and that these steps are sufficient in most cases to disclose any material discrepancies in quantities or the inclusion of any considerable volume of obsolete or slow-moving stock. By "material discrepancies" is meant discrepancies which involve a money value sufficiently large to have a bearing on the client's financial position.

After all, the banker can scarcely seek more than the assurance that the same degree of reliance may be placed on the item of inventories as, say, on the item of the reserve for bad debts. The banker will no doubt feel he has that assurance when he understands that the auditor who is properly qualified for his work exercises diligence and all the skill and resources at his command to satisfy himself concerning the physical aspects of inventories (as well as the clerical accuracy and the basis of valuation) just as he employs diligence, skill and available information to determine the adequacy of the reserve for bad debts. He would no more consider relying solely on the certification by responsible officers concerning quantities and marketable condition of the inventories than upon the assurance of the credit manager that all bad and doubtful accounts had been written off and no losses

would be sustained in realization of the accounts receivable carried on the books.

Perhaps the best definition of the auditor's responsibility with respect to inventories is that set forth in the pamphlet *Verification of Financial Statements*, issued in its revised form by the federal reserve board in May, 1929. That definition is given below:

"The auditor's responsibility with regard to inventories falls naturally into three main divisions—

- (a) Clerical accuracy of computations, footings and recapitulations.
- (b) Basis of pricing.
- (c) Quantities, quality and condition.

"The auditor's responsibility under the first two headings is clear. He must undertake sufficient investigation of the inventories to satisfy himself that the clerical work has been accurately done and that the goods are valued in accordance with the usual commercial practice—that is, at cost or market price, whichever is lower.

"With regard to the quantities, quality, and condition of stock, the auditor's duties and responsibilities vary with the circumstances of each case. The auditor is not a valuer and can not have intimate knowledge of many classes of business. He must generally rely for information as to quantities, quality and condition upon the responsible officers and employees of his client, which he should supplement by such tests and confirmations as his skill and experience may indicate for the type of enterprise which he is examining. In the case of a business in which the verification of quantities, quality and condition does not call for technical knowledge and presents no substantial difficulties, his responsibility is greater than it is in others where expert knowledge is essential to the correct determination of quantities, quality and condition of the stock or where the volume is very large. The auditor must, however, use diligence in every case to convince himself that quantities, quality, and condition are correctly recorded."

It may be well to point out that the pamphlet referred to is submitted by the federal reserve board for the consideration of bankers, merchants and manufacturers as well as accountants and auditors. The fundamental principles laid down in it have been adopted almost universally by the public accounting profession as a guide in the verification of financial statements. For this reason, if for no other, it would seem that every bank credit officer should be familiar with the contents of this pamphlet, as he would thereby be helped to a better understanding of the scope of the work undertaken by public accountants. However, it may be remarked parenthetically that nothing is so helpful to a better understanding of the mutual problems confronting banker and accountant as the existence of local chapters of the Robert Morris Associates and of the state society of accountants and the close coöperation of those two bodies.

In the foregoing definition of the auditor's responsibility with regard to inventories it is stated that "the auditor is not a valuer and can not have intimate knowledge of many classes of business."

Maurice E. Peloubet, in an excellent article which appeared in the December, 1928, issue of *THE JOURNAL OF ACCOUNTANCY*, has cited several classic examples (which are by no means far-fetched) of the difficulties which confront the auditor who would undertake also the functions of a valuer. One of these examples concerns the auditor engaged in taking and valuing the inventory of a jobber in jewelry, which includes, among other things, unset precious stones; another, the inventory of a manufacturer of heavy machinery which includes, among other things, various alloy steels. In neither of these instances, as Mr. Peloubet points out, would the determination of quantities and weights be particularly difficult, but it would indeed require an auditor of remarkable attributes to recognize and classify the colors and imperfections in the various precious stones and the nature and percentages of the alloys in the steels, all of which have a direct bearing on the value of the commodities.

Further extraordinary talents would be required to enable the auditor to place a value on the remaining articles to be found in the inventories of the jobber in jewelry and the manufacturer of heavy machinery, to say nothing of those he would have to possess when in the course of his practice he moved on to the inventory of a manufacturer of chemical compounds, a jobber in hardware, a textile mill producing cloth of mixed cotton and wool, an oil refinery, a department store—but the list can be extended indefinitely. Moreover, if an auditor were possessed of all these unusual qualifications he would still be unable to exercise them all in taking and valuing the inventories of his clients, unless he were possessed also of the ability to be in several places simultaneously, for it is safe to assume that the majority of his clients close their books on December 31st.

Many bankers recognize, at least to some extent, the difficulties which now confront the public accountant who endeavors to take or supervise his clients' physical inventories, but they believe that ways and means could be devised to overcome those difficulties and thus enable the public accountant to assume, in every instance, complete and unqualified responsibility for every aspect of the inventories. In fact, a banker once suggested this end could be achieved if firms of public accountants (at least those whose practice is national in scope) would maintain, as an adjunct to their accounting staffs, a corps of men thoroughly qualified by technical training and experience to take and value the inventories

of their clients. The services of this corps would be available to all offices of the firm and the technical training and experience of its individual members would be sufficiently diverse to cover the entire range of industries represented by the firm's clientele.

This is indeed an arresting suggestion but, quite apart from other considerations which render the scheme impracticable (such as the difficulty of securing men so qualified), the expense of maintaining an adequate corps of technical experts would make the cost of audits absolutely prohibitive. It is obvious that the field of each member of the inventory corps would necessarily be restricted to a few related industries and that a sufficient number of men of similar qualifications would have to be retained to meet the requirements of all clients represented by those industries. Therefore, members of the inventory corps would be idle much of the time and it is altogether possible that a group of, say, twenty-five clients would be called upon to bear the annual salaries and traveling expenses of perhaps fifty or more men required to take and value their inventories. This, of course, would be in addition to the fee for the remainder of the audit.

Now let us return to the inventories of the jobber in jewelry and the manufacturer of heavy machinery and see what steps could be taken by the auditor who remains within his province as a verifier of financial records (by which is meant all records having a bearing on his clients' financial position) to satisfy himself that, to adopt the language of the federal reserve board, "quantities, quality and condition are correctly recorded." First of all, he would ascertain by whom and in what manner the inventories were taken and valued, in order to determine whether or not responsible and qualified employees had been assigned to the work and adequate measures had been taken to safeguard against errors in count, description, valuation and computations. These enquiries would, of course, indicate whether a deliberate misstatement of quantities or values could be accomplished by one employee or would require collusion on the part of two or more and whether those in position to falsify the inventories would have an interest in doing so. They would also reveal the nature and extent of the available records, reports and memoranda which could be referred to as a check on the quantities, quality and condition of the commodities.

Having thus obtained a comprehensive idea of the strength or weakness of the inventory plan and the records with which he



had to work, the auditor could then determine the method of verification to be employed. However, before proceeding with the work of verification he would ascertain whether the rate of gross profit earned during the period under review, on the basis of the inventories submitted to him varied materially from the rate earned in previous periods; he would also compare it with the rate earned by other jobbers in jewelry (or manufacturers of heavy machinery) during the current period if, as is frequently the case, that information were available to him. A comparison of the rates of gross profit earned from year to year is highly informative, but the competent auditor will never lose sight of the fact that uniformity of rate is by no means conclusive evidence that the inventories are substantially correct as stated. For example, the apparent maintenance of the jewelry jobber's rate of gross profit might have resulted from an over-valuation of inventories sufficient to offset the decline that actually may have taken place as a result of trade conditions. By the same token, a noteworthy fluctuation in the rate of gross profit does not necessarily mean that the inventories are incorrectly stated, but it does put the auditor on notice to see that the fluctuation is accounted for logically and to his entire satisfaction.

A "spot check" of quantities and descriptions shown by the inventories could then be made. Qualified employees of the client would be called upon to point out all the precious stones of a certain description or value per carat (or steel containing a given percentage of a specific alloy) on hand at the time the "spot check" was undertaken. These would be counted and weighed by the auditor and the quantities would be traced back to the date of the inventories by the application of quantities shown by authentic records to have been purchased, sold and used in manufacturing operations during the intervening period.

The number of different articles selected by the auditor for the purpose of this "spot check" would depend upon circumstances but in any event would be sufficient to afford a comprehensive test of the inventories.

This procedure would reveal any errors in the quantities and description of those particular articles appearing in the inventories, unless, of course, those errors were exactly perpetuated, through accident or design, by improper description of the quantities on hand at the date of the "spot check" or in the records for the intervening period. The accidental occurrence of that

condition would be extremely improbable and to accomplish it by design would require an extraordinarily good memory on the part of the person doing it. However, if the auditor had the slightest reason to suspect that such a condition existed he could obtain a further check by ascertaining the quantities of those particular articles shown by the inventories at the beginning of the period under review and could build up book inventories at the end of the period by the application of quantities purchased, sold and used in manufacture during the period.

The facility with which book inventories could be built up or the auditor's count carried back to inventory date would depend entirely upon the nature and extent of the records, but the fact remains that it could be done with sufficient accuracy to disclose discrepancies of substantial amounts even if it entailed, in the case of diamonds, for example, the classification of every purchase and sales invoice within certain narrow limits of price range per carat. For this purpose, the yield per carat disclosed by sales invoices could be reduced to approximate cost (and thus classified within its appropriate price range) by the application of the average percentage of gross profit earned per carat, as revealed by the examination of all purchases and sales invoices during the period under review.

A comparison of the quantities of a given article included in the inventories with the sales or use of it during a period of time sufficient to cover the natural business cycle would afford enough information to form the basis of an inquiry concerning slow-moving and obsolete stock. This information must be amplified by the knowledge of the current trend of demand and of abnormally large purchases made because of temporarily favorable market conditions.

In both instances mentioned above, the nature of the commodities makes it possible to determine quantities by actual count, weight or measurement when taking physical inventories. However, it sometimes happens that the quantities shown by physical inventories are, as a matter of practical necessity, based to some extent on estimates. When that is the case, the auditor must satisfy himself that the estimates are predicated on conclusions sufficiently logical to withstand criticism and to be productive of substantially accurate results. The following instance will serve to illustrate this point; it also indicates somewhat the extent to which authentic records may be utilized in the course of an audit.

An auditor was engaged in making his initial examination of the accounts of a steel mill which had previously been examined by another auditor. This mill had on hand several thousand tons of heavy melting steel scrap and cast scrap consisting of the usual assortment of irregularly shaped objects such as boilers, radiators, car wheels and axles, railroad rails and spikes. The company did not then follow the practice of segregating scrap into several distinct piles and keeping a record of the track scale weights of the scrap placed in each and confining withdrawals to one pile until that pile was exhausted; instead, all the scrap was piled along the runway of a traveling crane, and one book inventory account was kept for each class of scrap. This runway had nine well defined "bays" formed by the uprights supporting the crane track, two of which were reserved for cast scrap, while the remaining seven were given over to heavy melting steel scrap.

As it was obviously impracticable to move several thousand tons of scrap in order to obtain the actual weight, the inventory of scrap was taken in the following manner:

Each "bay" was sub-divided into fifteen sections, the actual dimensions of which were, of course, known. Measurements were taken from the crane to the top of the scrap pile in the exact center of each section and thus the height from the ground was ascertained.

Proceeding on the assumption that irregularities in stacking would tend to offset each other, the company looked upon each section as a perfect pyramid. As both the base and altitude of each of these pyramids were known the theoretical cubic content of the scrap pile was readily computed as between the two bays containing the cast scrap and the remainder containing the heavy melting scrap.

The cubic content was converted into tons by the application of the rate of 60 pounds to the cubic foot in the case of heavy melting scrap and 75 pounds in the case of cast scrap. These rates were determined by the plant superintendent and plant engineer in the light of their experience as to how such scrap would stack.

The book inventories which the company kept for each class of scrap showed the quantity on hand at the beginning of the period (which had also been determined in the manner set forth above), the actual track scale weight of purchases less the customary trade allowance for dirt, rust, etc., and the scale weight of with-

drawals as shown by the furnace-charging reports, and the auditor made comprehensive tests of the authenticity of those records by reference to the documents supporting the entries. The discrepancy between the book and physical inventories was not so great that it could not be accounted for by a reasonable variation in the actual amount of dirt and rust from the trade allowance for those factors. The computations of cubic content of the scrap pile, duly supported by original documents showing the engineers' measurements, as well as the conversion into tons, had been verified by the auditor and, with one possible exception, the assumptions entering into those calculations seemed logical, and the results appeared to have been borne out in a general way by the relatively small discrepancy between book and physical inventories.

The exception was the conversion rate of 60 pounds to the cubic foot in the case of heavy melting scrap and 75 pounds in the case of cast scrap. Neither the plant superintendent nor the plant engineer was able to furnish more tangible evidence in support of those estimated rates than the assertion that experience had taught them that scrap would stack so as to average approximately those weights. While the auditor had not the slightest reason to doubt the sincerity of these assertions or the practical knowledge of the men giving them, he was not content to accept the estimated conversion rates without making a strong effort to obtain proof of their substantial accuracy, despite the fact that his certificate accompanying the accounts would necessarily state that the inventories were "certified as to quantities and marketable condition by responsible officers of the company."

The auditor thought it reasonable to suppose that scrap stacked in freight cars would average about the same weight per cubic foot as that in the scrap pile. Therefore, it appeared that, if it were possible to ascertain the cubic content of a number of freight cars in which deliveries had actually been made, an approximate conversion rate could be established, as the track scale weight of the scrap in those particular cars would be known. Inquiry revealed the fact that an equipment record was published by the railroads which contained precisely the information required, and the auditor's resultant tabulation yielded weights per cubic foot for each class of scrap which bore out very closely the conversion rates of 60 pounds and 75 pounds estimated by the plant superintendent and plant engineer. In preparing the tabulation the

auditor was careful to maintain the proper ratio between the number of cars loaded to weight capacity, those over-loaded and those under-loaded and thereby to avoid arriving at a fallacious average.

The methods of verifying the clerical accuracy and bases of valuation of inventories and of proving title to the merchandise will not be discussed here. Those methods are more or less obvious in principle and the auditor's responsibilities with respect to them are clear. However, it should be emphasized that those phases of inventory work lend themselves much more readily to accidental or intentional misstatements than do the physical aspects and that their verification is possible only by reference to records and documents the examination of which falls within the recognized province of the auditor.

It is not the purpose of this article to suggest that no misstatements of inventory quantities or descriptions, whether accidental or intentional, can take place without detection by the auditor. However, it is the purpose to point out that misstatements involving sums sufficiently large to have a bearing on the client's financial position will rarely go undiscovered by the auditor who is thoroughly qualified for his work as such if his instructions permit him the latitude to exercise those qualifications.

## Accounting for Waste

BY A. W. MOSER

Manufacturers faced with the problem of overproduction usually adopt one of two methods to adjust their factory's output to existing requirements. One consists in partly or completely closing down the plants until demand can catch up with supply. This plan involves the laying off of factory hands for a more or less extended period. With the other method, practically the whole of the factory force is retained, but the number of working hours is more or less reduced. Instead of being fully deprived of their regular income, as in the former case, the workers will here receive at least part of their periodic pay. To which one of the two ways of procedure a factory management will give preference in any given case depends on the kind of industry, the general policies of the management and many other circumstances.

Delving into this question, however, is not my purpose here. I wish to refer rather, in the first place, to the economic waste involved with either of the methods mentioned. Very often a manufacturer is compelled to resort to one of these emergency measures in order to keep away more serious troubles or distress from his business. It is, nevertheless, questionable whether sufficient thought is usually given, and especially in the present trying times of general readjustment, to a third possible manner of bringing supply and demand into closer alignment.

Let us assume a hypothetical factory producing a standard article used all the year around, carrying a retail price  $P$  and entailing a cost price  $p$  per unit; if  $D$  be the usual trade discount, then  $(P-D)-p$  is the manufacturer's normal gross profit per unit. There are regularly  $n$  workpeople on the payroll in this place, working 50 hours a week and producing a total of  $N$  units an hour; the average wage rate per hour is  $w$ . We will further assume that direct and indirect labor constitute 50% of the cost of production  $p$  per unit, so that  $n.w = \frac{1}{2}N.p$ , and of the balance of the cost price, namely of  $\frac{1}{2}N.p$ , 35% be made up of charges more or less independent of production intensity, such as overhead expenses, space charges, taxes, insurance and depreciation. It follows then that  $35/100 \times \frac{1}{2}N.p$  is an expense item, a fixed burden, always present whether there be great or decreased factory activity. The item amounts here in a year to  $35/100 \times \frac{1}{2} \times N.p \times 50 \times 52 = 455 N.p$ .

Let us go a step further. In the hypothetical factory chosen as an illustration (the conditions indicated parallel to a certain extent those of an actual case) business declined more than a year ago to such a degree that it became necessary for the management to proceed to a substantial curtailment of output. The prospects were that such action would have to be taken for a much longer period than would be the case if confronted merely with an ordinary or seasonal depression. To accomplish the reduction in question it was decided, in agreement with local laboring men, to cut the working time from 50 hours to 27 hours a week (3 days) and this was to continue as long as the slack demand. Also it was agreed that there should be no dismissals of workmen. It was felt in all quarters that in this manner the interests of labor would be best served.

Supposing that the hourly rate of output  $N$  remains unaltered for the 3-day week, then only  $27 \times N \ 52 = 1404 \ N$  instead of  $50 \times N \ 52 = 2600 \ N$  units, as before, will now be produced a year. It also follows that part of the fixed burden amounting to  $35/100 \times \frac{1}{2} \ N \cdot p \times (50 - 27) \times 52 = 209.3 \ N \cdot p$  will not have been absorbed by normal production charges in the course of a year. Hence the actual factory cost per unit will no longer be  $p$ , although all expense rates may have remained the same, but has risen to  $p + \frac{209.3 \ N \cdot p}{1404 \ N} = 1.149 \ p$ , that is an increase of nearly 15%.

If the usual trade discount  $D$  be  $33\frac{1}{3}\%$  and the relation between production cost and retail price such that  $P = 3 \ p$ , then there normally remains a gross profit of  $\frac{1}{3}P$ , as will be found in the expression  $(P - D) - p$ . Hence, with the cost price per unit standing at  $1.149 \ p$ , this gross profit is lowered from  $.33 \ P$  to

$$(P - \frac{1}{3}P) - \frac{1.149}{3} p = .28 \ P. \quad \text{The difference } .33 \ P - .28 \ P = .05 \ P$$

must be considered as an absolute economic waste, since, while a charge to the producer, it benefits nobody, neither public nor labor. The latter must be satisfied in the case here considered with slightly over one half of its normal weekly pay, and the public pays the same price for the article as before, while for the owner there will result a lower net profit or none at all.

For many manufacturers the conditions may be more favorable than those described here. But there probably are as many instances where the indicated economic waste proves at least

equally considerable. If it were only a question of an operating loss and nothing else, it would mean that somebody else (suppliers or labor or public) must have made a corresponding gain. Nothing of the sort, however, takes place in the case of this economic waste. The more is waste reprehensible and it should be eliminated from our industrial picture wherever conditions will permit it.

The management of our factory might have done well, therefore, to consider the advisability of taking some course other than reducing the working week or shutting down wholly or partly. Why not the third plan? If a loss must be taken in any event, then why not, if possible, make it at least somebody's gain, in the interest of the whole community?

The economic law of supply and demand governing the price of a certain commodity works in such a way that with the supply given, as in our instance, the price to a large extent regulates the demand, particularly as far as goods for consumption are concerned. This means that lowering the price will increase consumption and vice versa, though the proportion in which this interaction takes place may be very different for different articles.

Supposing that, instead of reducing the working week, our management had chosen to maintain the normal production schedule and to apply that part of the fixed burden lost with a 27-hour week to a reduction of the cost price  $p$ , followed by a corresponding cut of the retail price  $P$ , this action would find expression in the following figures:

Normal production a year: 2600  $N$  units;

Uncovered burden with 27-hour week: 209.3  $N \cdot p$  a year, where  $N$  denotes the normal production rate per hour and  $p$  the cost price per unit. Therefore

$$\text{reduction of } p = \frac{209.3 N \cdot p}{2600 N} = .080 p.$$

Consequently, the new cost price is  $p_1 = .920 p$  and, if the relation previously adopted of  $P = 3p$  be retained with respect to  $p_1$  and  $P_1$ , a new retail price results in  $P_1 = 3p_1 = 2.76 p$ , that is a retail price reduction of 8%. One third of this is due to lower production cost, one third is borne by the factory's sales and administrative departments in the form of lower gross profits and one third by the dealers.

In times of depression, a retail price reduction of 8% from the level of a boom period may not prove enough for many articles in order to stimulate retail demand so as to bring it again in line



with normal production capacity. In such circumstances and provided that labor shall not be relatively worse off than before, is it not fair to take into consideration a lowering of wage scales? It could probably be shown that in most instances where the procedure here suggested is carried out, labor actually fares better with a certain wage cut than with reduced working hours at old rates, or with only part of the men working and the rest filling the ranks of the army of unemployed. Efficient and progressive firms make every effort to keep their workers on full schedule; but for the best success labor's intelligent coöperation is also necessary.

To carry the idea a little further, we will assume that our management estimates that a reduction of 20% of the retail price  $P$  is indicated in order to bring the price in harmony with prevailing economic conditions and secure sufficient demand to warrant maintaining the contemplated normal production schedule. It is also felt, and this is an important consideration, that with markedly lower production costs, it would be far less risky and therefore more commendable to produce at times for stock than would otherwise be the case.

We have arrived already at an 8% reduction of  $P$  by applying an unabsorbed portion of the factory burden to cost of output and thereupon passing the benefit to the retail trade, let us now determine how much the wage rate  $w$  should be adjusted downward in order to permit a drop of 20% in the retail price.

Earlier in the discussion it was assumed that expenses for labor represent 50% of the cost price; but with wages changed, that is lowered in our case, that ratio may no longer hold good. However, for simplicity's sake we work on the assumption that the costs of other items, such as raw materials and power, etc., have equally gone down and that consequently labor's contribution to the cost continues to be 50% of the total. Also the relation shall be  $P_2 = 3p_2$ , where  $p_2$  is the new cost and  $P_2$  the adjusted retail price, the same as we had before  $P = 3p$ . Since  $P_2$  shall be .80  $P$  (20% lower), we have further

$$P_2 = 2.4p = 3p_2, \quad \text{or} \quad p_2 = .80 p$$

Inasmuch as the virtual elimination of the economic waste previously complained of has already brought down the price to

$$P_1 = 2.76p = 3p_1, \quad \text{or} \quad p_1 = .92 p$$

there remains as part of the original cost  $p$  to be covered through wage reduction alone .12  $p$

which means that a scaling down of the wages by 12% would be

sufficient to bring ultimate retail price reduction from 8% up to 20%, provided that the other costs are becoming similarly lower, as we have assumed.

We have conditioned the wage cut in the application of our plan on the requirement that the workpeople shall be relatively not worse off. Let us examine the status of labor at this moment. Under the 27-hour week plan, with original wage rates intact, a factory hand received  $27 w$  a week,  $w$  being the hour rate. The plan outlined above requires the men to do their regular 50 hours' work, but will net them weekly  $50 \times .88 w = 44 w$ , instead of  $27 w$ . For  $w = \$1.00$ , this means \$17.00 more a week.

Briefly to summarize the advantages thus secured, we may say that no man is thrown out of work; that the workpeople as a whole fare better than under any other emergency plan; that the public is benefited; and particularly that there is no economic waste. Hence if a similar policy were carried out in the main industries, the standard of living would not be lowered but raised, and the general condition of the country would thereby be not adversely, but favorably affected, notwithstanding the contrary view sometimes expressed by banquet speakers and others.

Accountants are keen observers of business conditions and detectors of waste; and what I have written is not news to them. However, as it is with figures that many things can best be expressed and most convincingly brought home, I have chosen this method to illustrate the importance of the economic waste resulting from the non-absorption of part of the factory burden by production. As long as there are only isolated cases of this kind, the effects are not felt in the vastness of our economic structure. The matter is different to-day. The intangible losses, unseen and even unsuspected by many, that the country suffers at this time as a consequence of the conditions existing, must aggregate a very formidable total and decidedly affect the living-cost level.

Incidentally I contend that a judicious and quick adaptation of wage scales to new conditions would benefit labor, that a comparatively small cheapening of production may entail a much larger reduction of retail prices and that lower production costs permit a manufacturer much more readily to produce ahead of momentary demand.

# The Herrings and the First Great Combine

## PART II

### THE HANSEATIC LEAGUE IN ENGLAND

BY WALTER MUCKLOW

#### THE SITE

From the earliest times the German merchants had a depot behind Cannon street station, near the foot of the narrow Dowgate hill bordering the west side of the station. Apparently this neighborhood had for centuries been a centre of activities, for in few London streets have there been found more Roman remains than in Thames street, along a part of which ran the old Roman river wall, built on oak piles, overlaid by a stratum of chalk and stone and covered with hewn sandstone set in cement. In places this wall is twenty feet thick and some of the beams were 18 inches square.

The Easterlings, as the early German merchants were called, first settled here and occupied the Hall of the Easterlings: later the merchants of Cologne held a part of Dowgate: and subsequently these two united, being then known as the "Merchants of Almaine" and owned the "Dutch Guildhall." The site was important, for in early times Dowgate was the only city gate opening to the river; therefore, it controlled foreign traffic and was of great value to the Germans in their efforts to govern this important business. It is probable that London Bridge, in some form, existed from Roman days, and in 1008 during the fighting against the Danes who had ascended the river, vessels were moored to the piles of the bridge and dragged down the entire structure.

In Saxon days Thames street was a fashionable place occupied by many nobles, e.g., Queenhithe was the queen's hythe, while the surrounding neighborhoods were devoted to special trades, as for instance Garlic hill, where garlic was sold to flavor strong food, and the Vintry, where all Bordeaux merchants unloaded their lighters and sold their wines.

It was not until after the treaty of Utrecht in 1474 that the site became known as the Steelyard, but antiquaries and etymologists

have quarrelled as to the origin of the name. Some claim this name is English and was given to the property because there was situated on it the great balance of the city of London, known as the Steelyard, on which were weighed all goods exported or imported. Others claim that the name is an Anglicized form of *Stahlhof*, or *Stalhof*, a place where staples are sold. In the various records it is spelled *Stelyard*, *Stillyard*, *Stilyard*, *Styleyard*, *Styleyered*, *Stillyerde*, *Stylleyarde*.

The property faced the river and was bounded on the north by Thames street, on the west by Dowgate hill, or, possibly, Cousins avenue just to the west, and on the east probably by *Allhallos lane*. Eventually the Steelyard became in effect a fortress, surrounded by a high strong wall, which contained few windows.

There appears to be no doubt that our word "sterling" is closely connected with this early trade, although the nature of the connection has given rise to more argument.

It is generally believed that about the twelfth century a credit system of trading was adopted, barter was abandoned and coinage substituted for it. Originally the pound was a pound of silver, the pound weight becoming the pound of currency, but often the metal was debased and the coins were clipped, and some authorities claim that in the reign of Edward I, the pound of the *Easterlings* maintained its purity and weight and became the recognized standard. Objections to this origin of the word are based on the undisputed statement that the word "sterling" was in common use long before Edward's reign, and signified an English silver coin of which 240 formed a pound.

The coins of William II are stamped with a small star or, in old English, a "stearling," while coins of Edward the Confessor bear the figures of birds which are said to be starlings, or "staerlings," although the die-cutters of that day fail to convey their meaning clearly, and it is quite possible that the figures may be intended to represent doves.

Be that as it may, the sterling coin was generally accepted in Europe and quickly earned for itself the reputation for purity, which it has never lost.

#### HISTORY

The history of English trading runs far back, for English merchants lived abroad as early as the eighth century, if not before, and dealt in merchandise and in slaves; but English exports were

raw materials. To encourage manufacturing Henry I settled Flemish weavers in Ross, Tenby and on the Tweed to weave the English wool, and weavers' guilds were formed in London and York as early as the twelfth century.

The Englishman allowed his goods to be exploited, as we should now say, by foreigners, and one of the earliest, most active, most important and longest enduring of all the branches of the Hanseatic League was that in England, which succeeded the German merchants who are known to have settled there under Ethelred the Unready (978). The activities were maintained for six centuries, until the reign of Elizabeth; and possession of property continued for nearly a thousand years until the reign of Victoria. In fact, London was chief of the four foreign factories, or "kantors" as they were called. The others were at Bruges, Bergen and Novgorod.

The first of the German settlers were described as "the men of the emperor," and of them little is known beyond the facts that they were Germans, that they were recognized as a distinct body and that they remained active; but it was not until 1157 that the first Hansa, that of Cologne, was recognized as such by Henry II.

We are not now concerned with the other foreigners, the Florentines and the Jews, beyond suggesting that, apparently, the chief reason for allowing any foreigners to settle in England was the fact that they were all money lenders, in posse or in esse. Canon law forbade Christians to exact interest, but Edward I offset this by allowing the Jews to collect interest up to 42%, although if a borrower failed to pay the lender could enforce payment of only the principal and three years' interest.

It was never intended that the life of foreign-merchants in England should be happy and many a restriction was placed on them. In the early part of the thirteenth century a foreign merchant was compelled to live in the house of a citizen: he might not sell at retail: he could buy only from a freeman of the city: he might not buy to sell again in the city: only on certain days could he sell to any one who was not a freeman: he might not bid against a freeman and might not remain in the city for over forty days—regulations far more rigid than any immigration laws now in force, or even suggested.

The restrictions on foreign trade were modified by the Carta Mercatoria in 1303, which granted privileges to foreigners in re-

turn for which they were to pay an increase of duties. This act is particularly noteworthy, for it established for the first time taxation on a national basis, and formed the basis of the many claims made by the league during the next two and a half centuries.

The story of the league in England, from the time of Henry II to that of Elizabeth, is that of a series of quarrels. A few instances will indicate the general condition. Apparently the first recognition of a "Hansa" was when Cologne lent Richard I the money required for his release from prison. In return for this loan he told them that he loved them but—what was more to their liking—he made them free of all tolls and customs of the city of London and soon after branches were established in a dozen English cities.

In 1282 we find the lord mayor quarrelling with the Hansa because its members had failed properly to repair Bishopsgate "and it was like to fall." The king ordered an "inquisition" and the league had to pay up and promise to do better in future.

Henry IV attacked the Steelyard and killed all within it: the league responded by closing all ports to English ships, seized vessels and pillaged English cities. Finally there was arranged the peace of Utrecht in 1474 and here occurs the first official mention of the name "Steelyard."

Thenceforward, the league maintained itself with marvellous tenacity. Its quarrels were almost continuous but, if it lost privileges under one king, it regained them under a successor. The royal favors ebbed and flowed without rest.

It was during Tyler's rebellion that the Londoners followed the example of the Gileadites who, when an Ephraimite could not say "Shibboleth," took him and slew him at the passages of Jordan. Instead of "Shibboleth" the Londoners demanded that the suspect should say "bread and cheese" and, if he failed to give the proper Cockney accent, he was promptly taken and slain at some passage of the Thames—an early proof, if one were needed, of the pride which Londoners have in their own tongue.

By the time of Henry VIII the relations became very strained. When a famine occurred in England in 1546, the league furnished supplies so liberally and so promptly that it earned the thanks of the privy council, but even this good action had its bad effects and England faced a condition even more serious than that confronting the federal farm board today, for the "bears" brought quotations of wheat down from 15s. 6¾d. to 4s. 11d. In 1551

King Edward VI became deeply embarrassed financially. Sir Thomas Gresham was living in Antwerp and he adopted tactics not unknown in modern financial circles, which resulted in such an inflation of the English pound that the king was able to pay off his heavy debts without recourse to the Hansa. Queen Mary led the league to hope for better times and remitted taxes to which it was subject, but these were later reimposed as she claimed the league had broken its promise.

The experience of Antwerp showed clearly the benefits which would result from foreign trade, such as the English established under the Tudors, and it indicates also the declining power of the league. It was a small city of straw-thatched houses when it first invited English trade: then it grew prodigiously and in fifty years house rent rose from 40 or 60 dollars a year to 400 or 600 dollars—a growth which compares favorably with any shown in the United States census.

In 1545 the league decided to move the Bruges factory to Antwerp; the city made various concessions and the cities of the league were to contribute to the expense of erecting buildings and so forth. However, the Hansa merchants had become tired of the monastic life under one roof and also of the domination by one city; therefore, many cities refused to contribute—the league had lost its hold on them.

About 1552 we find that Antwerp and Hamburg controlled the principal commerce of northern and middle Europe; their factors in the Steelyard set what prices they pleased on their imports and exports and, having the command of all the markets in England, with joint or united stocks they broke all other merchants, which suggests the question, Was this a trust or was it a forerunner of the modern chain stores?

The reign of Elizabeth bred crises of many a kind and one of these affected the league. Nearly every language of today was spoken at Queen Elizabeth's court. We know she could talk in six of them: there is no doubt she could keep silence in all, for has she not written "There is no marvel in a woman learning to speak. Marvel there would be had she learned to hold her tongue." The queen exercised on the league her talent for keeping petitioners in doubt for so long a time that the league applied to the emperor, to whom Elizabeth replied that she had done the league no wrong, as the taxes they complained of were imposed by her sister Mary. Then the league placed a bigger tariff on Eng-

lish goods and Elizabeth laid similar duties on all goods imported or exported by Steelyard merchants.

The final break with England occurred in 1589 when the league undertook to supply wheat and naval stores to the Spaniards, whom Elizabeth hated and with whom she was fighting, and English ships seized some sixty hulks owned by Hanseatic towns and sank them. The league protested vehemently. Can not one hear the queen as she tells them they are impudent, and she is willing to attribute this to the deficiencies of their amanuensis, but as for their threats "She sets no sort of value upon them"? She, or Drake, or the Almighty, had defeated Spain's great Armada the year before—what had she to fear from a lot of tradespeople?

On the league the queen exercised her powers both of speech and of silence: to its ambassadors she was as silent as she was to King Philip and kept them hanging over a gulf of uncertainties. But when, about the new year in 1597, the league ordered all Englishmen in Germany to leave within three months, she promptly countered on January 13th by ordering all Germans out of England within fifteen days. With this outgoing the Germans ceased to hold a privileged position in London. There is something pathetic in the account given by one of the merchants. In language which is biblical in its simplicity, he writes: "We left because it might not be otherwise: heavy of heart, Alderman Heinrich Langermann led the way, and we followed him, and the gate was shut behind us, and we might no how stay the night! Heaven have pity on us."

Up to the latter part of the sixteenth century the league had traded profitably in the Mediterranean, but at the opening of the seventeenth century the Hollanders had taken the best of this trade and the English were beginning to make inroads into it. Wheeler, the secretary and historian of The Merchant Adventurers, describes the condition with evident satisfaction, and of the league he says "Most of their teeth are out: and the rest but loose." In 1612 the king of Denmark claimed to be "Lord of the Baltic sea" which was more than England could stand, so she joined her old competitor and, for a while, the league, Holland and England were united; but no such union could last long, and in 1630 Gustavus Adolphus of Sweden complained to Germany that the league had dared to create the office of "General of the seas" to ravage and seize fortified towns. So a diet was called at



Lubeck, but the cities paid no attention to the summons, except to send notification that they had abandoned the league.

Probably the outstanding figure connected with the movement to expel the German merchants was Sir Thomas Gresham, the ardent supporter of The Merchant Adventurers. In his day German merchants had been living in England for some seven or more centuries and by their practical example had shown the English merchants how business should be conducted. Quite naturally, he thought that, even allowing for the proverbial thick headedness and slow wittedness of his countrymen, the time had come to reap benefit from the centuries of teaching, so he took a course similar to that followed in other countries in our own days—dismissed the instructors and set to work. Perhaps, too, he realized the advantage of dispensing with the middle man—and that is all the Hanseatic merchant was—and combining production and manufacturing with merchandising. The manufacture of saltpetre led to many a dispute and the story throws such light upon both manufacture and monopolies that it will be mentioned below.

Notwithstanding the bitterness of the disputes, the ownership of the Steelyard by the Germans was not questioned, and in 1601 possession was again given to them, after a temporary dispossession. James I turned a deaf ear to all requests for a restoration of old privileges and only four or five merchants continued to live in the Steelyard, among them one who wished to sell "94 fattes of Rhenish wine." Efforts to reestablish the Steelyard were made under Charles I and Charles II, but the buildings fell into decay and were destroyed by the great fire of 1666, although oddly enough the league continued to pay its quit of rent to the city and its pew rent to the rector of All Hallows church, up to the time of the fire.

From 1632 onward various attempts were made to get hold of the property, but it was finally decided that the Hansa merchants should continue to own it, so long as his majesty's subjects received fair usage abroad. Various delays and disputes came about rebuilding after the fire, but finally new buildings were erected, although much litigation occurred between the family of Jacobsens, who lived there as house masters, and the Hansa authorities, until the latter obtained undisputed possession in 1748. The place was rented as a store house and brought in some £1,500 rent a year.

Proposals to sell were made in 1838, and in 1853 representatives of Lubeck, Hamburg, and Bremen did sell it to Chas. Morrison and John Pamberton for £72,500. They in turn, sold to the Victoria Dock Company. The tower and part of the church were pulled down in 1863 to make way for improvements on Thames street and the Charing Cross Railway Company agreed to buy the property, but this company amalgamated with the South Eastern Railway, which acquired the site on May 11, 1865, and pays the city corporation an annual rent charge of £70. 3s. 4d., which "was the rate of payment mentioned in the act of 1475." The southern portion of Cannon street station covers approximately the whole site of the Steelyard, except a strip on the north side cut off for the widening of Thames street.

The Germans had taught the English all they knew of business methods—still they had enjoyed many privileges for centuries and had returned none. Their downfall resulted from many causes, political, social, economic, geographical, but above all from tenacity to monopoly, the inability of the league to move with the times.

#### SALTPETRE

Elizabeth's navy naturally required naval stores, and this term included gunpowder. As none of this was produced in England, all gunpowder was, of necessity, bought of the German merchants at their prices and, no doubt, the desire to be freed from this condition formed one of the reasons for supporting The Merchant Adventurers. The manufacture of gunpowder called for saltpetre and the history of this salt warrants a slight digression, for it gives us an intimate picture of some of the old laws, of the manner of administering them, of the crown's desire to create and profit from monopolies, and also of domestic affairs.

In Queen Elizabeth's day none of the nitrate fields which now supply saltpetre was known, and the article was manufactured by mixing organic matters with alkalis and exposing the mixture to the atmosphere. Throughout Europe there were many saltpetre plantations, or nitreries, as they were called, where the salt was thus made.

In England the salt was made from earth impregnated with animal matter, and, as gunpowder was used by the government and saltpetre was the principal ingredient, the government claimed a monopoly and the "saltpetre men" were empowered to

break open all premises and to dig up the floors of stables and even dwelling houses, as is testified by Archbishop Laud in his diary (December 13, 1624) when the saltpetre men "had digged in the college church of Brecknock and he requested that they be admonished."

In 1595 the saltpetre men of the Steelyard had been exercising their powers ruthlessly and the lords of the council directed the lord mayor to consult with the alderman of the Steelyard and to look into the matter. As a result the lord mayor reports "They found by the complaints of the citizens that the said saltpetre men entered the houses, shops and warehouses of poor artificers within the city to dig for saltpetre to the great hindrance of their trade."

Later, the king granted the earl of Worcester a patent for making saltpetre and gunpowder and he besought the king to direct that the lord mayor and aldermen be required to forbid anyone to dig for saltpetre in the city, excepting only our old friend John Evelyn the diarist. The earl agreed to deliver annually 60 casks of gunpowder at the Tower of London at 8d. a pound and as much more as might be required at 9d. a pound. In 1625 Charles I commanded by proclamation that no dovehouse or stable should be paved, but should "lie open for the growth of saltpetre" and that none should presume to hinder any saltpetre men from digging wherever they thought proper. This caused much dissatisfaction, and in 1656 the order was modified and directed that no saltpetre men should dig in any house or lands without first obtaining the leave of the owner. The method of manufacture as a crown monopoly continued in France until 1778 and was not abolished in Prussia until 1798.

#### THE BUILDINGS IN LONDON

The buildings at the Steelyard were German and differed from all the surrounding buildings. The chief of these was the Guild Hall, of which traces remained until 1851; to it there were three chief entrances, although the largest, the central one, was seldom opened. The hall served as a place for meetings and as the common dining room, while the master, or alderman, had a large house near the river. Between the two were gardens, where the young members played ball. In the later days these gardens were a favorite public resort, for there one could buy excellent Rhenish wine for three pence a bottle.

To encourage a healthy thirst, the Germans made a specialty of serving caviar, neat's tongues and salmon, but the place maintained an individuality and character of its own. It was different from the London tavern and resembled more closely a German beer garden. The garden was only a stone's throw from the Boar's Head tavern, while Prince Hal's town house abutted on the Steelyard in Cold Harbor lane, and we know that Shakespeare's company of actors frequented it, as indeed did the best of the land, churchmen, lawyers, warriors, sailors, until its destruction in the great fire. At its prime the Steelyard was in itself a busy city, goods continuously arriving and leaving by land and by water. It was entered only through small and carefully guarded gateways and its rooms were so crowded that many of the merchants were lodged in adjacent buildings.

It is reported that Shakespeare, Marlow and Henslowe all frequented the gardens, met there their patrons and discussed with them their plays over many a tankard. Pepys, quite naturally, had a liking for the place and the "Rhenish wine house" is mentioned frequently. In June, 1663, he there learned how to drink a toast in the French mode, which, says he, "I never knew before but it seems it is now the fashion." In 1666 he saw the great fire reach the Steelyard. In 1668 he visited another Rhenish wine house in Westminster and says—is it with pride or regret?—that he had not been in any tavern in a morning for six years.

As the league merchants prospered, their buildings increased in beauty and were superbly decorated. Among their greatest treasures were two pictures by Holbein, representing, respectively, "The triumph of poverty" and "The triumph of riches" which were subsequently given to the prince of Wales, in the days of James I, and were later destroyed by fire.

#### ORGANIZATION

The organization in London was similar to that at Bergen, but the roughest of the practices at initiation were abandoned, for it was realized the English would not approve of them. Still, admission to membership was difficult to obtain, and the severity of the trials through which applicants were forced to pass is almost beyond belief. While the tests were called "plays," over thirty of them were practised, the chief of which were smoke, water and the scourge.

The Steelyard was ruled by a council consisting of twelve members: namely, an alderman, two assessors and nine common councilmen. They were elected annually at new year and they formed a civil government, not subject to English but to German law. At the annual elections none could refuse election; if one attempted to do so he was fined for the first offence and unhanged for the second.

We must never forget that underneath all the diplomacy, all the bickerings, the wars and the alliances, the importance of the herring remains undiminished and brings us into distinguished company and leads that company into the most unexpected meetings. Who would suspect that this little fish was responsible for a close association between persons so utterly dissimilar as Sir John Falstaff and Jeanne d'Arc, the Maid of Orleans? Yet it was!

In 1428 the English were besieging Orleans and a train under the command of Sir John Falstofe, or Falstaff, attempted to bring food to the hungry army, for it was Lent and, although there was meat in abundance, no good Catholic dare eat it, and the soldiers were starving. Sir John was despatched from Paris with 300 wagon loads of food of which the chief item was barreled herrings. The Maid of Orleans had already inspired the soldiers of France, and they attacked Sir John, who was forced to entrench himself behind the loaded wagons. The French—and their allies the Scots—attacked prematurely and were repulsed, but they bombarded Sir John's position so heavily with their cannon that the balls burst the barrels, and the ground was strewn with more fish than fighters; "The battle of herrings" passed into history and the English lost their delicious herring pies, at the thought of which their mouths had watered and their spirits had been maintained.

It is generally admitted that this commander was the prototype of him who lives so blithely in Henry IV, under the name of Falstaff, who, in Henry V, we are told died, but appears in Henry VI as Falstafe. Can it be that his unquenched thirst, which Shakespeare has made immortal, was contracted on our herrings?

Again in the days of Cromwell we find Signor Gioviana Sagredo reporting to his chief at Venice that "a new foreign war was broke out with the Dutch on account of the herring fisheries." He adds that there were then three thousand Dutch ships sailing

the seas and that they admitted having lost 1,122 ships—the herring business was indeed of good size!

Still again in 1652, when the English and Dutch were quarrelling, the former instructed their ambassadors to insist on certain trading rights and on “the tenth herring which was due from the Dutch fisherman for permission to exercise their trade in the British seas.”

At the seaports a curious law prevailed. “The Hansa claimed that if any life escaped from a stranded ship, were it only a cat or dog, the authorities of the land where it was wrecked should have no right to claim either the ship or the cargo.”

#### MANNER OF LIVING

In a paper read by Cornelius Walford to the Royal Historical Society it is held that the first German settlement was made by an order of monks and that this led to the monastic form of life prescribed in later years. Be this as it may, the Steelyard was, in fact, a monastery devoted to money making instead of religion. No women were admitted within the gates and the resident men slept in separate cells, all of which opened into the common reception rooms. Of course, marriage was forbidden: but, worse still, if a member even visited one of the fair sex he was promptly expelled.

As in the continental kantors the gates were fast closed at a fixed hour every night and remained closed until the designated hour for opening in the morning, and this varied with the seasons. While all meals were eaten in the common hall, that hall was ably catered for and the merchants lived well and thoroughly enjoyed the best of the world’s delicacies.

Cleanliness, both of buildings and of person, was required and offenders were fined. They paid these particular fines in wax which was made into candles, and the Hanseatics kept them burning in the adjacent church of All Hallows the More. No bad language nor any brawling or drawing of knives was allowed. The fine for such an offence was 100 shillings. Fencing and games with the English neighbors cost a merchant twenty shillings. The city had ceded Bishopsgate to the Hanseatics on condition that they keep it in repair and defend it, thus relieving them of the “wall money” tax paid by citizens, for the maintenance of the city walls. Therefore, each Hanseatic merchant was required to keep in his room a full suit of armor and all needful weapons.

Apparently the merchants of the Steelyard realized in Queen Elizabeth's time that the Hanseatic League had seen its best days and they wished to separate from the control of Lubeck. When the league demanded a substantial contribution to its funds the Steelyard affected blindness to the letters and deafness to the appeals, but finally explained that business was low, taxes were high, and it would be glad if the league would refrain in future from making such demands.

#### BUSINESS STANDARDS

At the time of his initiation, each member took a prescribed oath and swore to obey the laws of the Hansa and "to deal justly towards everyone, whether powerful or humble, rich or poor. So help me God and his saints." There is no doubt that their standards of character and of merchandise were high, and when dishonesty was discovered the guilty was severely punished. They insisted that a bargain must be carried out, even if there were not so much as a scrap of paper, and if a merchant failed to pay his debts to one of the cities he was quickly unhansed. A like fate awaited a lender who misappropriated securities placed with him.

Unhansing meant ruin, for descriptions of bankrupts were published and no Hanseatic city might receive one or deal with one. If such a person were arrested, tried and found guilty, public exposure and imprisonment in irons were assured to him and, not infrequently, the severities inflicted led to his death. Not only were members to be honest in their dealings with each other, but they were bound to use honest weights and measures and to observe prescribed regulation marks as to the quality and quantity of the merchandise they sold. No futures might be bought or sold. They were prohibited from selling herrings not yet caught, grain not yet reaped and cloth not yet woven.

It was natural that, as generations rolled by, some laxity should creep into the lives of the merchants. The diet received complaints from England, as from other places, that the merchants "loved luxury, wine, women and gambling too well."

The merchants considered it their duty to monopolize trade for their cities, and, after some generations, this became an unconscious habit so strong that they failed to realize the rights which belonged to the nation in which the business arose. Their feeling differs slightly, if at all, from that exhibited by their copyists, the monopolists of our own day.

The members enjoyed the benefits of English laws so far as they suited them, but continued to make their own laws to suit themselves. The league had one aim. "Its stake was gold, the cup it fought and played for was the coined gold piece." When the English merchants began to rival the Hansas abroad, the league tried to influence local opinion by spreading various calumnies, but English commerce continued to grow. Hamburg was the first Hanseatic city to realize that oil is better than vinegar, and the Hansa there courted the English merchants and induced many to settle in Hamburg.

The German merchants differed from the Italians, who made profits through banking. The more hazardous and romantic business of trading appealed to the rougher men of the north. While, prior to the Reformation, they were Roman Catholics, the church was never allowed to have a voice in directing the affairs of the league, although contact with the church was close, for in mediæval times, the buildings were used for secular as well as for religious purposes and served the purposes of "banks, store-houses, market places and sanctuaries."

One basic difference existed between the Italian and the northern cities, for while the latter formed an association among themselves, the former remained individual and indulged in and suffered from all the costs of jealousy.

The league never wished nor undertook to rule countries, but through lending money and support to those who did rule, it maintained a control and evaded responsibilities. The older it grew, the more it indulged in pomp and ceremony and the more prominent was the part it took in every pageant. The members sought to gain and retain the favor of officers, and each year the lord mayor received a cask of sturgeon, or two casks of the finest herrings, or a hunderweight of Polish wax; while the aldermen received fifteen golden nobles wrapped in a pair of gloves, and the chief inspector of customs received twenty pounds.

Their attitude in religious matters might be described as similar to that of the Vicar of Bray. In Queen Mary's time, it was rumored that heretics were housed at the Steelyard, and Sir Thomas More searched the premises in the hope of finding writings of Luther. He failed to do so and was assured that no heretic could enter there; but a few years later, when the Reformation was established, we find all the Hanseatics in London attending Protestant services in All Hallows Church.



Not only did the Hanseatics rely upon the herrings as a basis of trade, but they firmly believed in the wisdom of using a herring, or a sprat, if there appeared to be likelihood of catching a whale. An instance of this occurred when Queen Mary ascended the throne and they hoped to regain royal favor, for among the features of the coronation procession was a hillock raised in Grace Church street, from the top of which four children cheered the queen while from the base there ran wine which cheered the crowds; and a couple more casks were opened in front of the Steelyard—proceedings which cost the merchants a thousand pounds or so.

In many of the kantors in Europe the league had its own church, but at London the members attended the church of All Hallows, where it held sittings up to the 17th or 18th century. After the great fire, one of the chief Hanseatic merchants, Theodore Jacobsen, gave a beautiful wooden screen to the church. This was removed when the building was destroyed, but it is still to be seen in St. Margaret's, Lothbury.

#### THE ATTITUDE OF THE ENGLISH TOWARDS THE LEAGUE

Throughout the existence of the league in England for the four centuries, from the time when Richard I pawned his crown jewels to Cologne until the time when Henry VIII borrowed and bribed and browbeat the league, certain fixed principles prevailed and disputes were endless. Impecuniosity is no new condition—ever since the world began some one, somewhere, has been poverty stricken. The league could always command money and therein lay its great power. From the time of Richard I, if the king found himself in need of money he sought the goodwill of the league, from which he could borrow. To obtain this he granted favors to the league. These favors quickly enabled the Hansa merchants to draw away trade naturally belonging to the English merchants; consequently the latter lost business, made no money and could pay no taxes. This condition at once affected the kings and, upon representations from their loyal subjects, they withdrew favors granted to the foreigners so that English trade revived and the king's treasury reaped the reward and continued to do so until circumstances led to another appeal to the league, when the same performance was repeated. The nobles and wealthy liked the league because it enabled them to obtain with the least trouble the many luxuries for which they longed. No such feelings actuated the merchants; they borrowed no foreign

florins; they used few foreign luxuries, but they found foreign merchants put on an equal footing with them in their own home ports; yet frequently they were prevented from trading in those ports from which the foreigners came.

There is no doubt that the Germans were far better traders, and from them the English merchant learned, perhaps unconsciously, certainly slowly, for it took him centuries to form similar associations such as The Merchant Adventurers. We can not be astonished at the jealousy of the English merchants when we find that in 1551 they exported only eleven hundred pieces of cloth, while the Steelyard exported forty-four thousand pieces in the same period, and we are told that the Steelyard's profit on cloth alone amounted to £61,000 a year.

English merchants were slow in organizing. The first association of which we know was that of The Merchants of the Staple, the origin of which is somewhat obscure, but probably it was founded, not by the merchants so much as by King Edward I in order to define and restrict the channels of export and so facilitate the collection of his customs, especially on wool, hides and tin. Under Edward III there arose the Mercers Company, of which The Merchant Adventurers appears to have been an offspring, which was granted a house at Antwerp. Among the principal contributing causes of the decline of the league in England was the awakening of the English merchants to the possibilities and profits of trade beyond their own country and their learning the principles of foreign trade. Their chief teacher was the league.

An outward and visible sign of this change is to be found in The Merchant Adventurers, a company chartered about the middle of the sixteenth century. Prior to that time English privileges had been granted only to the Hanseatic League, but in a short half century that league was forced to leave England. It is true that The Merchants of the Staple lasted until the eighteenth century: but this business was to export English raw produce and, as the English manufacturers grew, these products were used at home, and it was the business of The Merchant Adventurers to trade in manufactured articles.

And so passed this great structure. Nothing now remains but a few buildings and a romantic story, although its influence, unseen and often unsuspected, still affects the world's commerce of today, where its pupils have outdistanced their instructors. What profit can be gained by studying the old page? Even if,

like the Coliseum of Rome, all that is visible is a ruin, will the spirit of enterprise be reincarnated in some future form of consolidation or coöperation free from many of the weaknesses of the past, even as the stadium of the ancients is revived in the stadium of today, and the athletics of the present generation, however subject they may be to adverse criticism, do indicate an advance over the belief that slaves, prisoners and Christians existed for the purpose of nourishing hungry beasts of prey? Is it too much to hope that the future will see some form of world wide coöperation under which the products of all lands may find a common and a constant market?

# Students' Department

H. P. BAUMANN, *Editor*

## AMERICAN INSTITUTE EXAMINATIONS

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

### EXAMINATION IN AUDITING

November 12, 1931, 9 A. M. to 12:30 P. M.

*Answer all the following questions:*

No. 1 (10 points):

Define turnover in merchandising or manufacturing, and state how it is to be ascertained.

*Answer:*

The turnover of a merchant or manufacturer indicates the number of times the average inventory is purchased and sold during a given period.

The rate of turnover is ascertained by dividing the cost of goods sold, i. e., the opening inventory plus the purchases or cost of manufacturing, less the closing inventory, by the average inventory for the period. Some accountants divide the cost of goods sold by the opening inventory only, if the beginning and closing inventories are approximately the same amount. However, if the books are closed at the end of the "natural" business year, when inventories are the lightest, it is apparent that the rate of turnover determined by a divisor represented by the smallest inventory of a period will not correctly state the rate of turnover, particularly in an industry of a seasonal nature.

The most desirable method would be to divide the cost of goods sold by an average of the monthly inventories, which method would give effect to the variations in the amount of stock-in-trade during the period.

No. 2 (10 points):

In a qualified certificate appears the following sentence:

"Depreciation of capital assets has been charged on the basis of the cost of such assets and not on appreciated values."

In the accompanying balance-sheet surplus is stated as a single item.

Your client, a prospective investor in the stock of the corporation in the case, asks you to explain what the sentence means, and to advise him as to what further information he should obtain.

What explanation and what advice would you give him?

*Answer:*

The sentence appearing in the qualified certificate would indicate that the capital assets had been revalued at an amount in excess of cost, and that the offsetting credit had been made to the surplus account, rather than to a capital surplus account. Whether an operating deficit account was converted into a credit balance, or surplus account, can not be determined without knowing the amount of the surplus account shown in the balance-sheet, or the amount of the surplus arising through the revaluation of the capital assets. Nor can it

be known from the information given, the amount of free surplus available for dividends. Furthermore, with the depreciation charged on a basis of the cost of the capital assets, what is the company to do when these assets have been fully depreciated? When the amount of the accumulated reserves for depreciation has been built up to the cost of the assets depreciated, the excess of the asset accounts over the reserves for depreciation will represent the amount of the write-up of the capital assets. Is this write-up to be written off to surplus, or how shall the company treat it?

The accountant should advise his client to secure an analysis of the surplus account so that it may be distributed between earned, contributed, or other capital surplus elements. In addition, the client should obtain copies of the operating statements for the past five or ten years, with balance-sheets at the end of such periods. With this information, he should be better prepared to decide whether the investment is a desirable one. If he is unable to secure this data, he should be advised to refrain from making an investment in the company.

No. 3 (10 points):

You are instructed to make the first audit of the accounts of an estate covering a period of two years from date of decedent's death. His assets comprised bonds, stocks, mortgage notes, notes and accounts receivable and cash. At the same date there were direct liabilities consisting of notes and accounts payable and contingent liabilities in respect to notes payable endorsed by decedent, who, however, was not engaged in business.

You find that appropriate investment records and ledger accounts have not been kept, that journal entries without explanations have been made in the cashbook, and that the final cash balance in the cashbook is not in agreement with the balance shown by the bank statement.

State what audit procedure you would follow in verifying the gross and net estate, and the gross and net income of the estate for the two-year period under review.

*Answer:*

From a certified copy of the inventory and the liabilities of the estate as shown by the probate court records, the accountant should prepare a chart of accounts and open a ledger with accounts for the assets and liabilities of the estate. The net credit, that is, the amount of the excess of assets over the liabilities, should be entered in an account with the estate principal. From the cancelled cheques, invoices, statements, correspondence and other data, the accountant should, after entering the transactions in a cashbook and journal, post these items to the proper accounts in the ledger. To verify his record of the cash receipts, he should trace his entries through to the deposits shown in the bank statements. A further check of these receipts may be had by preparing a schedule of the investments against the dividend and interest lists to learn whether all dividends and interest which should have been received during the period held have been accounted for.

The contingent liabilities in respect to the notes payable endorsed by the decedent should be listed as of the day of his death and accounted for (1) as eliminated by payment of the notes by the makers, (2) as still being unpaid, and (3) as having become actual liabilities to be taken up on the books of the estate.

Any additional assets, such as interest accrued at date of death, or cash dividends declared prior to date of death, and any additional liabilities, such as

## *Students' Department*

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debts of decedent, taxes, fees, interest, etc., should be taken up on the books. Gains or losses on realization should be recorded and posted to the estate-principal account.

The assets as shown by the inventory of the probate court should all be accounted for, as disposed of or still on hand. The method and the authority for the disposal of such assets should be carefully considered.

The securities shown to be on hand according to the records should be verified by inspection or confirmation, and should be valued at the inventory value, or at cost if purchased since the date of death. A comparison of market values, if any, should be made. The cash on hand should be verified by count, and that in the banks should be reconciled with the bank accounts, per books, and confirmed by the depositaries.

No. 4 (10 points):

To what extent is a public accountant liable to a creditor of his client who relies upon his certified statement and suffers a loss because of a condition existing in the affairs of the debtor-client which was neither disclosed nor indicated in the accountant's report? State your reasons and discuss.

*Answer:*

In the case of *Ultramares Corporation v. Touche, et al.*, it was held that an accountant could be held liable to a creditor of his client who relies upon the certified statement and suffers a loss only in the case of fraud to which the accountant was a party.

The basis of the suit was that the accountant, if negligent, could be held for the amount of the losses sustained by creditors of the client as a result of their having relied upon his report in advancing credit. In effect, this theory placed the accountant in the position of being an insurer to any and all, known or unknown, who might give credit to a client. It can readily be seen, that if this theory were upheld, the accountant would be required to increase the scope of his audits, and to increase his charges to compensate him for his risk to such a degree that the cost of examinations and investigations would be prohibitive. And what assurance would the accountant have that his client was not in collusion with certain creditors?

The conclusion is obvious, because had the court held that the accountant could be held liable for negligence to others than his client, accountancy, and certain other professions, would soon disappear.

No. 5 (10 points):

You are employed by the estate of A, deceased, to audit the books and render a statement of the affairs of the firm of A & B, of which A was a member. In the course of your audit you find an item debited to insurance expense designated merely "life-insurance premium." On inquiry you learn from the book-keeper that it was paid on a joint-life policy of the two partners. You find no record of the receipt of the face of the policy.

What does this suggest to you, and what steps will you take in the matter?

*Answer:*

The accountant should ascertain the beneficiaries of the insurance policy, and the amount payable to them, from the insurance company direct, from the partnership agreement, or agreements, or from the administrator or executor of the estate of his client, A. If the partnership is the beneficiary, the amount collected should be distributed, when received, in the partnership profit-and-loss sharing ratio. If the estate of A is the beneficiary, the administrator or

executor should be so informed. If the surviving partner B is the sole beneficiary, the amount collected does not have to be recorded upon the partnership books.

In the statement of affairs which the accountant is engaged to prepare, he should show as an asset the face of the policy, less any cash surrender value set up on the books, if the partnership is the beneficiary.

No. 6 (10 points):

Define the following terms:

- (a) Cost less accrued depreciation.
- (b) Cost of reproduction new less accrued depreciation.

State the conditions under which each method may be used in valuing capital assets.

*Answer:*

(a) Cost less accrued depreciation is the excess of the purchase or construction cost of the assets less the accumulated provision for wear and tear. The provision for depreciation should be based upon the cost, less the estimated residual value, spread over the estimated life of the asset. This method is commonly used for balance-sheet purposes, when the necessary information is available.

(b) Cost of reproduction new less accrued depreciation is a physical inventory of the fixed assets, valued at an estimated purchase or construction price as at the date of the appraisal, against which is provided a reserve for depreciation, based upon estimated life, or actual wear and tear. This method of appraising the fixed assets is generally used (1) when the records are incomplete, (2) when departmental costs are desired, (3) when a reorganization, or new financing is contemplated, (4) and by public utilities for the purpose of rate-making.

No. 7 (10 points):

You are auditing an importer's accounts in behalf of a bank which has established commercial letters of credit for large amounts in favor of the importer. The latter signs "trust receipts" when he receives the goods he imports.

How far would you pay attention to the practice of the importer in paying the bank drafts drawn under these credits, and why?

*Answer:*

Inasmuch as the importer does not own the specific merchandise which he receives and for which he signs a trust receipt, but holds such goods as collateral to secure the draft of the bank drawn under the letter of credit, he may be required to remit immediately to the bank all collections which he receives for goods sold, up to the amount of the draft. In all likelihood, he deposits these collections in a general fund, and draws his remittances to the bank from this fund. In following this procedure, the bank is placed in the position of a general creditor, rather than a secured creditor, during that period between the actual selling of the goods and the remitting of the proceeds to the bank. The practice followed by the importer should be brought to the attention of the accountant's client, the bank.

No. 8 (10 points):

In making an audit of a stock-broker's accounts you find the following accounts of customers:

- (a) Customer Abbott:  
Ledge debit balance, \$9,500.

*Students' Department*

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- Market value of "long" securities held by broker to protect the account, \$6,000.
- Above account is guaranteed by Customer Brown.
- (b) Customers Carter & Davis, joint account:  
Ledger debit balance, \$75,000.  
Market value "long" securities held, \$95,000.
- (c) Customer Elliott:  
Ledger debit balance, \$25,000.  
Market value "long" securities held, \$6,875.  
Above account is guaranteed by Customer Flynn, whose debit balance is \$88,000, and  
Market value of "long" securities held is \$191,000.  
Elliott also guarantees the account of Gaunt, whose debit balance is \$100,000, and  
Market value of "long" securities is \$60,000.
- (d) Customer (1) Harris, and  
(2) Harris, special:  
(1) Harris' account shows debit balance, \$12,500 and "long" securities, \$15,000.  
(2) Harris', special, account shows debit balance, \$2,100. No securities held.

What procedure should be followed in confirming these accounts? Give reason for each case.

*Answer:*

(a) A statement should be sent to Abbott with a request that he confirm his account. A copy of the statement of Abbott's account should be sent to Brown with a request that he confirm his guarantee of the account, in order to ascertain whether he had withdrawn his guarantee.

(b) A statement of the joint account should be sent to both Carter and Davis with a request that they confirm the account and that they state their respective interests therein. The purpose of requesting this information of the account is to obtain a confirmation of all of the transactions of the period, particularly those ordered by either which might not have been assented to by the other. The data as to the relative interest held in the account by Carter and Davis should be of interest to the broker in connection with such data as he may have of the financial worth of both Carter and Davis.

(c) A statement of his account should be sent to Elliott with a copy of the statement of the account with Gaunt with a request that Elliott confirm his own account and his guarantee of the account of Gaunt.

A statement of his account should be sent to Gaunt with a request for confirmation.

A statement of his account should be sent to Flynn with copies of the statements of the accounts of both Elliott and Gaunt with a request that Flynn confirm his own account, his guarantee of Elliott's account, and his guarantee of Elliott's guarantee of Gaunt's account.

The purpose of obtaining these confirmations is to ascertain the correctness of the several statements, that the several guarantees have not been withdrawn, and that Flynn's guarantee of Elliott's account includes Elliott's guarantee of the account of Gaunt.

(d) A statement of his account and the account, Harris, special, should be sent to Harris with a request for confirmation of both accounts for the purpose of ascertaining, particularly, that the account Harris, special, is not a dummy account being conducted to cover transactions of some one other than Mr. Harris.



No. 9 (10 points):

When accounts receivable have been sold or hypothecated, how should they appear on the books and/or the balance-sheet which you are certifying without qualification?

*Answer:*

(1) When the accounts receivable have been sold without a guarantee, that is, without recourse, no mention need be made of that fact on the books or the balance-sheet.

(2) If the selling company guarantees the accounts receivable sold, a footnote to that effect should be appended to the balance-sheet. The receipt of cash should be charged to the cash account on the books.

(3) When accounts receivable have been hypothecated, the amount so pledged should be set out separately in the receivable section of the balance-sheet with a parenthetical note stating that these accounts were pledged to secure loans of blank amount, per contra. The liability to the loaning company should appear as a separate item on the liability side of the balance-sheet with a note to the effect that the loans were secured by accounts receivable of blank amount, per contra.

The accountant, before rendering an unqualified certificate, should examine the contract of sale in the first case to make certain that the sale was without recourse.

In the second case, the accountant should secure a confirmation of the accounts receivable sold, and the amount of the contingent liability represented by the guarantee of the uncollected accounts at the date of the balance-sheet. In the third case, confirmations of the pledged accounts, and the amount of the unpaid balance on the loan should be obtained from the loaning company.

No. 10 (10 points):

Criticize the following description of the verification of income in an audit report:

"Cash received from the rental of boats by the hour or day has been verified from the daily appointment schedules kept by the dock tender (and not by the bookkeeper or cashier). All other receipts for monthly rentals, berth privileges, etc., are received in the form of cheques by mail. As daily receipts recorded agreed with deposits as shown by bank statements, we accept as correct the original entries for these revenues as found in the journal."

*Answer:*

If collusion between the dock-tender and the bookkeeper is suspected, the client should employ "checkers" to investigate. However, while the accountant, according to his report, has verified the receipts shown by the books, he has not verified unrecorded revenues which might have been received. It is possible for the bookkeeper to withhold the entries of cheques received for monthly rentals, berth privileges, etc., and to substitute these cheques for currency received for the rental of boats, which currency he might pocket. The total of these recorded receipts would agree with the deposits as shown by the bank statements, and the embezzlement would not be apparent in reconciling the bank accounts. The accountant should, therefore, secure the original deposit slips from the bank, and check these against the entries in the cash receipts books to learn whether the bookkeeper has substituted cheques in his deposits of the company's funds for currency receipts recorded in the cashbook.

*Students' Department*

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STATEMENT FOR CREDIT PURPOSES

*Editor, Students' Department:*

SIR: One of our clients has several bank accounts. In the middle of December one of these was closed. In preparing a statement for credit purposes as of November 30th, how should the cash in this bank be treated, under each of the following conditions?

1. Balance November 30th . . . . .	\$40,000
Deposited to date of closing of bank . . . . .	20,000
Balance in bank when closed . . . . .	15,000
New sales to date of closing . . . . .	18,000
2. Balance November 30th . . . . .	40,000
Deposited to date of closing . . . . .	None
Balance in bank when closed . . . . .	15,000
3. Balance November 30th . . . . .	10,000
Deposited to date of closing . . . . .	20,000
Balance in bank when closed . . . . .	15,000
4. Balance November 30th . . . . .	None
Deposited to date of closing . . . . .	20,000
Balance in bank when closed . . . . .	15,000

In each case the money deposited to date of closing represents collections on accounts receivable.

With the banking situation as it is today, this question is a timely one and of interest to all accountants.

Will you kindly answer through the columns of an early issue of *THE JOURNAL*?

Yours truly,

LOUIS RESNIK

Lynn, Massachusetts.

While the balance-sheet purports to present the financial condition of the business as at November 30th, any subsequent transactions or facts that might affect the condition of the business must be considered.

In all of the above cases, the amount on deposit in the bank at the time of the closing was \$15,000, and, it may be safely assumed, the amount and the date of any recovery on this balance was unknown at the time of the preparation of the balance-sheet. It is suggested, therefore, that the amount of available cash at November 30th, the date of the balance-sheet, be shown as a current asset with a footnote stating that the X Bank in which was deposited a balance of \$15,000, was closed on December —, 19—. In the balance-sheet at subsequent dates, the amount on deposit in a closed bank should be transferred from the current asset section to a position below as this amount is not available to meet current liabilities. A reasonable reserve for the uncollectible portion of this balance may be set aside as a deduction from the amount on deposit.

## Book Reviews

ACCOUNTANTS' HANDBOOK (Second Edition), edited by W. A. PATON,  
*Ronald Press Company*, New York. 1873 pages.

Comparison of Professor Paton's *Accountants' Handbook* with that of Professor Saliers' is inevitable, and one gets the impression that the present edition is not so much a "second" as a completely revised one. It may be convenient to regard it chronologically as a successor to the Saliers' edition, but only as we note sometimes a sign stating that "John Jones" is the "Successor of Samuel Smith," doing business at the old stand. In fact the main resemblance between the two books is the format. Otherwise the entire rearrangement of subjects, differences in text and treatment, omissions and introductions of sections, make the Paton edition practically a new work. It will be regarded as an improvement or otherwise according to the users' opinion.

Fortunately the basic principles of accounting are so firmly established that either edition may be relied upon with confidence. In spite of the remarkable fluctuations in the business world during the last decade and the many weird and revolutionary proposals put forward by some writers to off-set inflation and deflation, standards have been maintained. Perhaps it may seem ultra-conservative to stick to traditional rules of valuations in these chaotic days, but it is better to have a good measuring rod for past and future comparisons than to plunge into the mire of arbitrary percentages.

Nevertheless there are some features hitherto obscure or controversial which are definitely and authoritatively treated in the Paton edition.

It is to be regretted that the subject of economics has been omitted in Professor Paton's edition. In view of the wild and spreading demand for "cheap money" in this year 1932 (just as in 1837 and other depression years), the basic principles of sound economics would be well worth instilling into the minds of users of this manual. Also it is somewhat surprising to find so little information about foreign exchange, a subject that is important to accountants and business men on our seaboards if not in the interior of the country.

W. H. LAWTON.

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DE OMNIBUS REBUS, by D. F. DE L'HOSTE RANKING, *Gee & Company*,  
London. 202 pages.

The late Dr. Ranking was one who played an important part in the training of the English profession of accountancy. He had probably coached as many students as any other man of his day and some of the ablest accountants now in practice owe their success in large part to the example and the instructions which Dr. Ranking gave with liberal hand. Following Dr. Ranking's death, it occurred to Robert A. Harting to select and to *Gee & Company* to publish from the writings of Dr. Ranking some of the work which seemed of most permanent value. The range of subjects in this posthumous collection is extremely wide and much of the matter is of interest, not only to accountants but to the general public. Indeed, there is very little about accounting in the whole book. It is hoped that this tribute to one who served the profession will meet with ready welcome and that the proceeds will be considerable.

A. P. R.

## 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.]

### *BALANCE-SHEET SHOWING CHANGE IN PAR VALUE OF STOCK*

*Question:* Will you kindly advise me how to treat the following items on a balance-sheet?

A corporation has an authorized and outstanding capitalization of 1,000 shares of \$100 par value each. It desires to return one-half, or \$50,000, in cash to its stockholders, representing one-half of the amount paid in by them for stock, and also to change the par value from \$100 to \$50 a share. All of this has been approved by the stockholders. The charter has been amended and has been approved by the secretary of state. At October 31, 1931, the date of the balance-sheet, nothing has been paid back to the stockholders nor has any of the stock of \$100 par value been surrendered for exchange for new stock of \$50 par value. I am not concerned with the income-tax question of the return of the money to the stockholders, but I should like to know how the matter should be displayed on the balance-sheet at October 31, 1931. Should it be shown as

1,000 shares par value \$100 outstanding..... \$100,000

or

1,000 shares par value \$50 outstanding..... 50,000?

If the latter, what disposition should be made of the \$50,000 that is to be returned to the stockholders?

*Answer No. 1:* As the par value of the stock has actually been reduced to \$50 by the filing of a certificate with the secretary of state, in our opinion the balance-sheet should show the capital stock outstanding at \$50,000, even though the certificates have not been exchanged nor has the reduction of par value been noted.

The balance-sheet should also indicate that \$50,000 is to be distributed to the stockholders. As the distribution has already been authorized by the stockholders, in our opinion the amount of \$50,000 should be shown as a liability, properly described.

As an alternative, a pro-forma balance-sheet may be prepared, modified to give effect to the proposed distribution. In such case it should, of course, be made clear in the heading and certificate that effect has been given to a transaction which has not as yet been consummated.

*Answer No. 2:* In our opinion, the situation may be treated in either of two ways:

(1) Present the balance-sheet on the basis of the old arrangement of capital stock and append a footnote to the effect that all necessary legal action has been taken to make a liquidating distribution of 50% of the capital stock and to reduce the par value from \$100 to \$50, but that the actual exchange of certificates and payment of the liquidating dividend have not yet been consummated.

(2) Give effect to the proposed alteration of capital stock by setting up as a current liability the amount of the liquidating dividend payable and by presenting in the capital-stock section a description of the shares on the revised basis. If this be done the balance-sheet should probably carry some such phrase as this: "Giving effect to reduction of capital stock by changing the par value from \$100 to \$50 a share, and the declaration of a liquidating dividend of \$50; all legal requirements having been complied with but the exchange of certificates not yet effected."

As a matter of fact, as the actual exchange has not yet been effected we believe that the footnote explaining the situation presents the least difficulty and puts the facts fully on record.

*TRANSFER FROM COMMON-CAPITAL-STOCK ACCOUNT TO  
SURPLUS ACCOUNT*

*Question:* A corporation is organized under the laws of ——— and the by-laws contain the following paragraph:

"The board of directors shall have power from time to time to fix and determine and to vary the amount of working capital of the corporation and to direct and determine the use and disposition of any surplus over and above the capital stock paid in."

The board of directors has power to allocate to surplus any sums received by the corporation from the sale of its common stock in excess of the amount allocated to capital by the board.

The corporation sells 100,000 shares of its common stock of no par or nominal value at \$50 a share (the 100,000 shares being the original issue) and receives \$5,000,000 in cash. It credits this \$5,000,000 to common-capital-stock account, and subsequently in accordance with the foregoing by-law the board of directors authorizes the transfer of \$4,000,000 from common-capital-stock account to surplus account.

In preparing a certified balance-sheet of the corporation subsequent to the date of the transfer, would an accountant be justified in showing the amount of \$4,000,000 on the balance-sheet as "surplus paid in" without any comment, or showing it as "surplus arising from sale of common stock in excess of amount allocated to capital stock by directors," or should it be added back to common capital stock outstanding?

## *Accounting Questions*

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Would it alter the conditions if it were ascertained that subsequent to the date of the balance-sheet, the greater part of the \$4,000,000 credited to "surplus paid in" had been disbursed to preferred stockholders in the form of dividends?

The company has no other credits to surplus.

*Answer:* We must assume that the question of legality is settled affirmatively by the extraordinary provision which allows the board of directors to "vary the amount of working capital of the corporation."

The question may be divided into two sections, one purely legal and the other accounting. The statement that the directors may from time to time vary the working capital of the company raises a legal point as to whether the term "working capital" means the actual capital of the company and whether this legally authorizes the directors to reduce or increase the capital without the usual legal formalities. We are assuming that it does so and the only point that remains is the method of stating the accounts. The question does not say how long subsequent to the paying in of \$50 a share on the issued stock, the directors made the transfer of \$4,000,000 to surplus, but we assume this also was justified legally. Even with these assumptions, the powers are, of course, unusual and dangerous. If the transfer to surplus was made practically concurrently with the issue of the stock, we see no objection to designating it as surplus paid in. If, on the other hand, it was made after some time had elapsed, we think it desirable that the surplus should be shown as a transfer from capital account by the board of directors, or, as suggested by the inquirer, as surplus arising from sale of common stock in excess of amount allocated to common stock by directors. We do not see how it could be debited back to the capital stock assuming the legality of the by-laws and a motion of the directors. It would not appear to us that the fact that a portion of the surplus paid in had been distributed as a dividend or applied to operating losses in accordance with the laws of the state of ——— would affect the manner in which the original credit was stated.

### *ADDITIONAL CHARGES TO COST PRICE OF COMMODITIES*

*Question:* Commodities like lead ore, coal, grain, greasy wool, coffee and pulp, purchased f.o.b. point of shipment, are subject to loss of weight in transit. Freight is paid on original gross weight, which includes moisture. Special charges, such as brokers' commissions, weighing and inspection fees, loading and unloading, etc., are incurred. The total outlay divided by the quantity actually received is the unit price which I have found recorded.

Does paragraph 55 (j) of *Verification of Financial Statements*: "If duties, freight, insurance, and other direct charges have been added, the items should be tested to ascertain that no error has been made. Duties and transit charges are legitimate additions to the cost price of goods, but no other factors should be added except in extraordinary circumstances," intend that each of the elements of cost enumerated below (even when adjusted to lower market prices) if set up in a book inventory is to be written off or is to be excluded from a computation of inventory value?

- (a) Loss of weight—essence of commodity.
- (b) Loss of weight—evaporation of moisture.
- (c) Freight on moisture content.

- (d) Moisture paid for at price of commodity.
- (e) Brokers' or buyers' commissions or expenses or purchasing department expenses.
- (f) Weighing and/or inspection fees.
- (g) Loading and/or unloading.
- (h) Hauling.
- (i) Insurance—transit and/or storage.
- (j) Cost of foreign exchange.
- (k) Additional loss of weight after receipt—either of essence of commodity and/or of moisture.
- (l) Storage charges or expenses.

*Answer:* Many commodities like those referred to are purchased today upon the basis of analysis, or if the packages contain foreign elements, they are graded and priced, so that, when the foreign elements are eliminated, the real cost of what is usable is the cost of the lot purchased.

All the items mentioned may, under conditions, enter into the cost of usable product laid down, either in the warehouse to be withdrawn, or in the plant ready for processing; and the auditor or accountant who has these elements to deal with can readily decide whether or not they are properly to be added to an initial invoice in order to bring the commodity to the point where it is to be used. This is covered by paragraph 55, if read in its broadest sense.

PERCENTAGE FOR FACTORY OVERHEAD

*Question:* One of our clients has recently perfected a gas water heater. He has consulted with a manufacturing concern for the probable manufacture of his water heater. This concern has submitted certain manufacturing costs which we would like to compare with similar manufacturing concerns in the United States.

As an aid to discussion, let us suppose that these percentages submitted by the manufacturing concern are as follows:

Labor.....	50%
Material.....	25%
Factory overhead.....	25%

Our client is particularly interested in the last, namely, factory overhead—25 per cent. Any data that you can furnish us which may be used for comparison would be very much appreciated.

*Answer:* We have gone through our files of clients in similar business and find their overhead ranges from 30 to 45 per cent. of their total manufacturing costs.

Your request states the overhead to be 25 per cent. of the manufacturing cost and also 50 per cent. of the labor cost, which, unless non-productive labor is included in labor cost, is somewhat lower than we find to be the case. Overhead, we find, runs from 60 to 75 per cent. of productive labor in a manufacturing business.

The bid may have been made to fill up a shop and to help carry a part of the overhead burden without profit during the present business depression. In that case the percentages probably are not derived from past experience.

## Current Literature

Compiled in the Library of the American Institute of Accountants.

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

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