Journal of Accountancy, July 1932 Vol. 54 Issue 1 [whole issue]

American Institute of Accountants

SINGLE COPY 35 CENTS PER ANNUM $4.00

The JOURNAL *of* ACCOUNTANCY

VOLUME LIV JULY, 1932 NUMBER 1

CONTENTS

Issued Monthly by

AMERICAN INSTITUTE PUBLISHING CO., INC.

Publication Office, 10 Ferry Street, Concord, N. H.

Editorial and General Offices, 135 Cedar Street, Manhattan, New York, N. Y.

President, JOHN B. NIVEN, 80 Maiden Lane, New York, N. Y.
Treasurer, JAMES HALL, 40 Exchange Place, New York, N. Y.
Secretary, A. P. RICHARDSON, 135 Cedar Street, New York, N. Y.

Entered as second-class matter at the Post Office at Concord, New Hampshire, under Act of March 3, 1879

Authors of Articles in This Issue of The Journal of Accountancy

M. A. Feldmann. Certified Public Accountant (Wisconsin). With Peat, Marwick, Mitchell & Co., Milwaukee, Wisconsin.

L. L. Briggs. Associate Professor of Economics, University of Vermont, Burlington, Vermont.

G. E. Klanderman. Certified Public Accountant (North Carolina). With Seidman & Seidman, High Point, North Carolina.

Important to Subscribers

When you notify The Journal of Accountancy of a change of address, both the old and new address should be given. Kindly write, if possible, so as to reach the publisher by the fifteenth day of the month preceding the date when a change is desired.

The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

[*Opinions expressed in* THE JOURNAL OF ACCOUNTANCY *are not necessarily endorsed by the publishers nor by the American Institute of Accountants. Articles are chosen for their general interest, but beliefs and conclusions are often merely those of individual authors.*]

VOL. 54 JULY, 1932 NO. 1

EDITORIAL

Whose Balance-sheet Is It?

One of the vitally important questions of modern accountancy—one upon which there seems to be a distinct cleavage of opinion—is that of the authorship and responsibility for the balance-sheet of any business concern. The word "balance-sheet," as used here, means not only the actual statement which is known by that name but also the supporting schedules, profit-and-loss account and other statements from which the balance-sheet is derived and by which it is sustained. It is quite a common thing to hear people speak of the balance-sheet of such and such an accountant prepared for the X corporation, and it is equally common to hear of the balance-sheet of the X corporation approved by such and such an accountant. These two methods of expression indicate the sharp difference of opinion as to what the balance-sheet actually is and also whose it is. There was a time when the accountant, so-called, was really a writer-up of books at the close of a week or a month or even a year. He was given certain books of account, most of them quite incomplete, and was told by word of mouth of some of the principal transactions of the period. It was his duty at that time to compile from these uncertain records, both written and oral, a statement showing the assets and liabilities of the concern with the resultant net profit or deficit. When there was no possibility of preparing such a statement from full records of transactions the balance-sheet was in effect the product of the accountant's knowledge, experience and to some extent his ingenuity. He took what was really a collection of fragments and constructed with them something which bore the appearance at least of a definitive statement. Today the accountant is not supposed to be a construction engineer. He is an analyst. In most cases the balance-sheet and other statements of the corporation or firm or other business entity are prepared by the concern itself from the books of account, minute books, etc., and the accountant's duty is now to investigate the records, test their accuracy and express an opinion upon the truth of the final statement. By an unhappy turn of fortune the word "certify" has crept into usage and we hear of the accountant certifying that in his opinion the balance-sheet clearly reflects the financial condition of the company. Passing over the impropriety of the word "certify" and its derivative "certificate" we find that the accountant does not make the balance-sheet but merely expresses an opinion as to how it is made and as to the validity of the material which goes into its making. It seems a little like a stretch of imagination, therefore, to describe the balance-sheet as that of the accountant. It is very much like saying that a new play is of the dramatic critic who merely expresses his personal opinion about it. (It would be an unkind punishment of the critic to lay upon his shoulders the burden of blame for all the things at which he has to look.) While admitting, for purposes of argument, at any rate, that the balance-sheet is, therefore, the balance-sheet of the corporation made by the corporation's own servants and that the corporation is responsible for the truth or untruth of its contents, it can not be forgotten that the accountant has a direct moral responsibility—and, some of the authorities would tell us, a legal responsibility—for the accuracy of the balance-sheet and the various items in it. The accountant professes to have the ability to express a valuable opinion upon the merits of systems of accounts, statements and all other forms of financial record. It is this claim that makes his work professional. If no question of opinion were involved the professional attribute would be absent. When the client engages the accountant, therefore, he does so with assurance that the accountant is competent to express an independent technical opinion and he is entitled to rely upon what the accountant says about the accounts. Therefore while the accounts are strictly things of the business concern, the accountant, the moment he passes an opinion upon them, assumes a moral responsibility.

When Should Changes Be Made? The question then arises how far the accountant may go in changing the form or contents of a balance-sheet which he is reviewing. Remembering that the balance-sheet is prepared by the corporation, it is a very nice point to determine how far the accountant may carry interference with the construction of the balance-sheet before certifying, to use the customary word, that the balance-sheet is correct. Here is where the different schools diverge. There seems to be a more meticulous insistance upon form by some of the smaller accounting firms than there is by the larger. There are many firms which insist absolutely upon adherence to their own chosen order of presentation and will not certify until the accounts have been brought into conformity with their own conception of what is correct. (We are speaking now solely of matters of form.) Some of the larger firms, as well as many of the smaller ones, do not lay stress upon detail and are inclined to accept without much question any method of presentation of facts which is not deceptive. They argue with a great deal of force that the balance-sheet is of the corporation and, if it truly and with reasonable clarity reflects the conditions, they do not feel that it is incumbent upon them to make changes purely for purposes of conformity to precedent. Probably both schools of thought are right. Certainly no one can condemn the accountant who insists upon adherence to the most minute detail of procedure. There is no possible question of the wisdom of such military precision. If it errs it errs on the right side. On the other hand, the more liberal accountant is probably right, but he is in danger always lest, in permitting what seem like unimportant departures from good practice, he may unwittingly allow an arrangement of facts in an order which will not tell the whole truth to the casual reader. Balance-sheets are bad enough at their best. It requires expert knowledge and sometimes a great deal of imagination to know what they really mean. The accountant who certifies is very often misled by his own comprehensive knowledge of the affairs of the company under consideration. Because he knows in his own mind what is back of some of the figures he feels assurance of their accuracy. But the shareholder or investor or any other person less familiar with details of the business is often unable to know what the balance-sheet is all about. Consequently there is a peril in permitting the publication of balance-sheets which wander too widely from established customs. They may tell the truth but tell it in such a way that no one will understand.

The Test is Absence of Ambiguity

It is generally considered by accountants that they must carefully guard against the utterance of any statements unless convinced that the form of such statements is reasonably intelligible. The accountant who adopts the conservative plan of procedure and insists upon rigorous adherence to form is safer. He can always fall back upon the defense that he has required everything that custom suggests. Many of the fine distinctions which arise will occur to every accountant of experience. The mere matter of order of assets or liabilities, the position of capital stock and many other formal questions will present themselves to anyone who considers the subject. There can not be a universally adopted form of balance-sheet for all concerns. There must be some flexibility—no one could lay down a rule of thumb which would be applicable for all practices—but there has been so much discussion of ownership and authorship of balance-sheets that it seems desirable at times to think about it. Every accountant will have to decide for himself how far he may permit deviation from the beaten path. It is always safest in the middle of the road—unless one happens to be a pedestrian on a motor highway. But there are, of course, many occasions when there must be individual choice of a route to follow. If the balance-sheet tells the truth so that any moderately intelligent person can not be deceived by it, it seems generally wise to approve it. If changes are required in order to meet the purposes of exposition the accountant must insist upon them, and if he signs a balance-sheet which does not comply with these requirements he is culpable. The details, the order, the classification of unimportant items—these things rest with the accountant and his conscience. It would be ideally perfect if every accountant were altogether infallible and if every statement bearing the signature of an accountant were brought into exact conformity with the accountant's own plan of presentation. Perhaps we shall come to those happy days, but in the meantime it is probably well to remember that the balance-sheet, although the property of the client, must never contain anything that could be reasonably misconstrued. Accountants should be on guard against any laxity at all in accepting forms which they do not entirely approve.

Trade-Union Policies

Structural repairs and alterations were in progress in a building in the city of New York. Painters, carpenters, plumbers, bricklayers and other artisans were at work. The ceiling of the ground floor had been plastered anew, and from the center of the ceiling was suspended a fragment of electric wire. The owner of the building, inspecting the work, noticed the piece of wire and told one of the plasterers to remove it. The man refused to do so, on the plea that it was work for an electrician and his union would not allow him to touch the wire. The owner reached up, caught the end of the wire and pulled it down easily, as it was not attached to anything. He then instructed the plasterer to complete his work. This is a true story. And it is one of the countless reasons why so many men who are skilled artisans are now out of work. Trade unionism has done much for the working man and for fairness in the relationships of capital and labor, but carried to such silly extremes it has done a great deal to prevent the undertaking of construction and other work. The absurd claims of labor unions have certainly checked building and developments of various sorts, and the country is now confronted with the spectacle of an almost total cessation of many kinds of work where trade unions control, while there is a fairly substantial volume of activity where the open shop prevails.

Unionism Outside the Trades

It is the custom of people who are not directly concerned with manual labor to regard the struggles and the absurdities of trade unionism with a somewhat supercilious superiority. Yet there is the same sort of spirit prevailing outside the realm of the artificer. Take the professions for example. Some of them are so dreadfully afraid that there may be encroachment upon what they justly, or unjustly, consider their prerogatives that they would surround themselves with restrictions which will prevent any alien foot from touching even the borders of their territory. Indeed, they go further and construct what seem to be movable fences, which they constantly attempt to push outward so as to enclose a little more territory and to prevent the alien foot. There is, of course, a deal to be said in favor of the theory that the cobbler should stick to his last and that no one who is not a cobbler should profess to be one; but on the other hand there are some things which are regarded as the exclusive right of groups of men which can not logically be so construed. As an illustration, let us consider a recent ėnactment of the Alabama legislature defining the practice of law. This act is reported in the *American Bar Association Journal* for February, 1932. The statute reads:

> Section 1. Only such persons as are regularly licensed have authority to practise law.
>
> Section 2. For the purposes of this act, the practice of law is defined as follows: Whoever, (a) in a representative capacity appears as an advocate or draws papers, pleadings or documents, or performs any act in connection with proceedings pending or prospective before a court or a justice of the peace, or a body, board, committee, commission or officer constituted by law or having authority to take evidence in or settle or determine controversies in the exercise of the judicial power of the state or subdivision thereof; or, (b) for a consideration, reward or pecuniary benefit, present or anticipated, direct or indirect, advises or counsels another as to secular law, or draws or procures or assists in the drawing of a paper, document or instrument affecting or relating to secular rights; or, (c) for a consideration, reward or pecuniary benefit, present or anticipated, direct or indirect, does any act in a representative capacity in behalf of another tending to obtain or secure for such other the prevention or the redress of a wrong or the enforcement or establishment of a right; or, (d) as a vocation, enforces, secures, settles, adjusts or compromises defaulted, controverted or disputed accounts, claims or demands between persons with neither of whom he is in privity or in the relation of employer and employee in the ordinary sense, is practising law. Nothing in this section shall be construed to prohibit any person, firm or corporation from attending to and caring for his or its own business, claims or demands; nor from preparing abstracts of title, certifying, guaranteeing or insuring titles to property, real or personal, or an interest therein, or a lien or encumbrance thereon.
>
> Section 3. Any person, firm or corporation who is not a regularly licensed attorney who does an act defined in this act to be an act of practising law, is guilty of a misdemeanor, and on conviction must be punished as provided by law. And any person, firm or corporation who conspires with, or aids and abets, another person, firm or corporation in the commission of such misdemeanor must, on conviction, be punished as provided by law.

Laws to Protect Lawyers

It seems that, if this act were administered with literal interpretation it would be illegal for anyone except a lawyer to draw a will or a lease or to prepare an income-tax return. This would indicate that bankers, real-estate men and accountants would be debarred from fields in which they have rendered important service. Apparently no accountant or other person not a lawyer could make a claim for refund or abatement of tax except on his own account unless he were regularly licensed to practise law. The lawyers have always been rather sensitive about their rights and privileges. In some cases they have seemed to think more about protecting themselves than about promoting the welfare of the general public. They have been able to obtain a preponderant representation in most legislative bodies and consequently have succeeded in writing into the laws all sorts of defensive statutes. Probably any other class of men with similar opportunities would have been quite as selfish. Many accountants are similarly exclusive and would attempt to prevent perfectly harmless activities of persons who are not accountants, lest the sacred precincts be invaded. The medical profession has rather more justification for rigid maintenance of the frontiers, because any encroachment into the field of practice might have serious effect upon the health of the people. But there is in all professions very much the same sort of tendency which induced the plasterer to refuse to remove a piece of loose wire. Quite recently there have been conferences between a committee of the American Bar Association, known as the "committee on unauthorized practice of the law," and representatives of the American Institute of Accountants to consider primarily the attitude of the bar with reference to operations which might by some stretch of imagination be classified as the practice of law. The negotiations between the two bodies were conducted, of course, in the most friendly and helpful way. There was, however, an evident desire to protect the lawyer from any remotest peril of interference with his practice. As always happens, there were two sides to the question and it became apparent during the discussion that there were times when the lawyer displayed an undesirable tendency to wander into the field of the accountant.

Tu Quoque

The representatives of the Bar Association suggested that the Institute should make a rule prohibiting accountants from attempting to practise law. The representatives of the Institute pointed out that accountants have no wish to permit the profession to interfere with legal practice and drew attention to the Institute's rule of conduct which reads, "No member or associate shall engage in any business or occupation conjointly with that of a public accountant which in the opinion of the executive committee or of the council is incompatible or inconsistent therewith." There has been a great deal of argument between lawyers and accountants about practice before the board of tax appeals. Some representatives of each profession would like to restrict to their own profession the right to appear before that board. The ideal arrangement, of course, is one in which the accountant and the lawyer appear together, each presenting those phases of the case which clearly fall within his purview. We think that the lawyers have been quite unreasonable in many of their efforts to build walls around themselves and we are quite sure that some accountants have been equally unwise, but it does seem a pity that professions, one of them very old and the other very new, whose pursuit runs closely parallel should not be able to carry on without conflict. Both professions have much to do for the welfare of humanity and can help enormously in the restoration of business stability. If only they would forget themselves for a little while and think of the body politic it would be all the better for them and the rest of us. One thing is certain, that the professions so long as they follow the principle of pure selfishness without compensating benefit to the public have no right to look down upon the most ardent advocates of extreme trade unionism.

Professional Accountants Could Assist Railways

In the April, 1932, number of THE JOURNAL OF ACCOUNTANCY appeared somewhat extended editorial comment upon the audit of railway accounts by public accountants. Those notes were instigated by a letter addressed to the shareholders of one of the great railroads by its president, recommending that a proposal to amend the bylaws so as to eliminate independent audit be approved. A correspondent who has had a good deal of experience in the audits of small, short-line railroads, writes expressing agreement with the comments which were published in these pages, and he urges that the question be revived from time to time so that there may not be an apparent acquiescence in the tendency to depart from the principle of independent audit. He says in part:

"People connected with organizations subject to supervision by governmental boards, or commissions, are apt to handicap themselves by too literal and narrow interpretations of the regulations. Railroad records are sometimes arranged so as to facilitate the assembling of data for reports to the interstate commerce commission, and the furnishing of vitally important cost data and other operating information may be overlooked. Perhaps some independent auditors have accepted too readily the established routine and methods, with the result that their work and reports have not been of much informative and analytical value to the railroad executives. It seems to me that railroads should not only have independent audits, but they should be audited with a view to developing more useful and necessary information and such revision of accounting methods as will make the organizations more readily responsive to managerial control."

Different Purposes in Investigations

There is, of course, a great deal of truth in the argument which our correspondent makes. The investigations which are made by representatives of the interstate commerce commission and other governmental bodies are not intended to produce the kind of information which leads to more economical administration and the attainment of better results. Perhaps the matter can be best expressed by saying that governmental investigation is solely retrospective. There are certain forms which must be followed, certain ways of keeping accounts which must be adopted, and certain statistical summaries which must be prepared, but it is seldom the function of a representative of the government to point out how improvements in service or administration might be brought about. It is well known that the function of the accountant is always to deal with facts, but nowadays it is also the duty of the accountant to report to his client things which he thinks would help the organization toward greater success. Here is one of the most important factors in this whole question, and unfortunately it seems to have been overlooked in almost every case. It must not be inferred that the accountant is supposed to dictate methods of management, but he is supposed to give the benefit of his advice based upon his experience not only in the affairs of a particular client but in the affairs of all other clients in similar business. That is the point which our correspondent has in mind, and it is one that can not be too emphatically stressed.

Election of Auditors

At the monthly meeting of the Chamber of Commerce of the state of New York, June 2, 1932, a report and resolutions submitted by a special committee on "auditors of corporation accounts" were unanimously adopted. The entire report appears in the *Bulletin* of the American Institute of Accountants issued on June 15th, and there is not space available to reproduce the report here. Briefly, however, it discussed the question of adopting the practice (which prevails in other countries) of electing auditors instead of having them appointed by the board of directors or the management. Every accountant and, in fact, every man of business has a vital concern in this important question, and it is eminently gratifying, especially to this magazine which has consistently advocated election instead of appointment of auditors, that the following resolutions should have been proposed by the committee and should have been unanimously approved:

> RESOLVED, That the Chamber of Commerce of the state of New York urges upon the directors of all corporations whose accounting methods are not under federal or state supervision but whose securities are dealt in publicly, to amend their by-laws to require that independent certified public accountants shall be selected by the shareholders; that the reports of such accountants shall be rendered in full to each and every director and be made available for inspection by the shareholders; and that the text of the accountants' certificate be spread on the minutes of the company and printed in the annual report; and, be it further
>
> RESOLVED, That the chamber recommends that all close corporations and firms as well as counties, cities and other political subdivisions which require substantial loans from financial institutions or others, inaugurate the practice of periodical audits by independent certified public accountants.

No doubt this action of the Chamber of Commerce of the state of New York will have effect. It is too much to hope that the entire scheme of things in this country will be changed overnight by any action of any group of men however influential, but it is something to have on record one of the most important organizations of business men in the country as in favor of abandoning the prevailing system and adopting the more desirable plan of election. There has been in these pages so much advocacy of the principle of election as opposed to appointment that it is surely unnecessary to repeat the arguments. All that need be done now is to express gratification.

Undesired Publicity

As we go to press we learn that more than one inquiry has been received by the Institute regarding the ethical aspects of the publication in a recent issue of a magazine of an article dealing with a number of leading firms and personalities in the accounting profession. The criticism presupposes that the article was written with the approval of those whose names were largely featured in it, but we know enough of the facts to be able to state that such an assumption is by no means universally warranted. Indeed, the article bears internal evidence of an absence of coöperation on the part of some at least of those whose names were prominently displayed, the information given in regard to some persons being obviously obtained from public sources and the photographs either snapshots or press pictures. Other persons may have approved the article—all that can be said at the present time is that this is another case in which it would be unsafe to generalize. Even in the case of those who actively coöperated it can scarcely be suggested that they acted unethically or even showed a lack of delicacy. When a magazine determines to issue such an article it is, unfortunately, impossible to prevent it from doing so, and an accountant who knows his name is to be featured may think it wiser to coöperate to the extent necessary to eliminate incorrect and objectionable statements. Publicity, whether welcome or unwelcome, is an almost inevitable accompaniment of success.

The Outboard-motor Industry

By M. A. Feldmann

History and Development

The evolution of travel through the air has been comparatively recent; the development of travel over land and water is as old as history itself, and even superficial consideration will disclose that most of the romantic themes in the development of the race are to some extent concerned with the ability of man to propel himself over the seas with the greatest of dispatch. Thus, the Greek legend of the Argonauts and their quest of the Golden Fleece, the sagas of the ravaging conquests of the Vikings, and the romantic rise and fall of the shipping on the Spanish Main prove the deep abiding interest and importance attached to the conquest of the waters.

The development of the various propelling forces which were successfully applied toward locomotion on the water, may be left for the most part to the prolific field of historical record, and the primary task of this thesis will be a consideration of a subdivision of the evolution of propulsion of watercraft by means of the internal combustion engine, namely, the development of the outboard motor. The outboard-motor industry today ranks as one of the important in a host of tremendously startling industrial achievements, and its growth and development is inseparably connected with the commercial and recreational activities on the waters of all nations.

The first outboard motor made its appearance in 1909 during an era of world-wide quickening of interest in the internal-combustion powered automobile and motorboat. It would naturally be expected that with the imaginative appeal created by the spectacle of rapidly moving vehicles upon land and water, some person or persons would conceive the idea of building a power plant for small watercraft which would be attached to the stern of the boat and extend into the water. The first really successful outboard motor of this kind was built by Ole Evinrude in a small machine shop in Wisconsin, and therefore, the development of the outboard motor industry is centered about the name of this pioneer. Wisconsin may justly claim to be the home of this industry, for, in addition to the fact that the first successful motor was there produced, it still ranks as the producer of more than 40 per cent. of all such motors made in the United States.

The first outboard motor built in 1909 by Evinrude was of 1½ h.p. single cylinder, two cycle, which, when placed in an ordinary rowboat, propelled it at a speed of approximately six to seven miles an hour.

Evinrude continued his experimental development of this engine until he produced a motor that was sufficiently trouble-free to permit of practical use and distribution. With little or no capital, he built twenty-five of these motors which he hoped to be able to sell through personal contact. It was his wife and business partner who foresaw the possibilities of Evinrude's inspiration and, over his protests, inserted an advertisement in the leading sports magazines. The replies and inquiries were so numerous that it immediately became apparent that an assured demand awaited a more constant output of the engine. Because of his inadequacy of capital, Evinrude formed a company in 1910, and $5,000 of outside capital was secured.

With this limited amount as a base, by dint of careful management and planning, the Evinrudes produced and sold in the period of four years from 1910 to 1913, more than 30,000 motors. In 1913, for internal reasons, the company was transferred to others for a consideration approximating $300,000, and the business continued operations in Milwaukee under the name of Evinrude Motor Company.

Evinrude did not again engage in the manufacture of outboard motors until 1920, when he organized the Elto Outboard Motor Company. This company produced a light twin-cylinder motor, which was the first really marked advance in design and construction, as the maximum speed was materially increased, the weight was lessened and vibration was eliminated to a considerable degree.

Incidentally, it may be mentioned that one of the greatest factors which militated against the use of the outboard motor and, correspondingly, the overcoming of which greatly increased the sales appeal of the motor was vibration. The excessive vibration of the early motors had a destructive influence on both the motor itself and on the boat to which it was attached. At first attempts were made to overcome this difficulty by manufacturing specially constructed, braced, and even steel, boats, many of which remain in use, but this presented an obvious limitation to popular use, since it involved a much higher price to the buyer. Therefore, one of the problems of the industry has been a problem common to all manufacturers of internal-combustion engines, namely that of reducing vibration, and this has been accomplished to a marked extent in late years by the utilization of light alloy pistons and by greater accuracy in machining and balancing moving parts, such as the crank-shaft and fly-wheel, etc.

Up to the year 1925 the motors were used principally for pleasure and for certain commercial purposes. The motors of that day were capable of propelling the ordinary rowboats, on which they were used almost exclusively, at a speed of about ten miles an hour.

Another important turning point in the history of the industry was the introduction of the step- or hydro-plane in 1925. This type of boat skimmed over the water, as distinguished from a displacement boat, and rendered possible the attainment of exceptionally high speeds, with the result that the motors were introduced in racing and other aquatic sports. Racing associations and clubs were organized, and a popular interest and demand soon resulted, which manifested itself in more widespread use with correspondingly greater sales and production.

After this innovation, the development of the motors and of the industry assumed a more rapid pace. Each successive year marked the establishment of new speed records, and each year saw the development of new types and classes of motors. Annual racing classics were inaugurated, of which the Albany to New York race on the Hudson is still probably the most important. In 1928 the winner of that race averaged less than 30 miles an hour, whereas the 1931 winner averaged 42 miles an hour, and the total elapsed time was less than the time required by the New York Central's crack train for the same run. The 1931 annual race from Milwaukee to Chicago on the open waters of Lake Michigan was run by the winner in one hour and fifty-six minutes, which was the fastest time ever made by any type of motor boat between those points. In 1931, also, a new speed record for an outboard motor boat was established at slightly over 55 miles an hour.

Naturally enough, this development and stimulation of interest in the motors resulted in the organization of several new companies for the purpose of competing in manufacture and marketing. By the close of 1928 five fairly large competing firms were engaged in the industry in the United States, each with similar models in practically every motor class. These companies were the Evinrude Motor Company and Elto Outboard Motor Company, both at Milwaukee, Johnson Motor Company, at Waukegan, Illinois, Lockwood Motor Company, at Jackson, Michigan, and Caille Motor Company, at Detroit.

The Johnson Motor Company was the outgrowth of the Johnson Motor Wheel Company of South Bend, Indiana, and had been engaged in the production of small motors for bicycles. Its operations in that field were more or less limited, and in 1921, attracted by the growing interest, it reorganized and subsequently acquired a plant at Waukegan, Illinois, for the manufacture of outboard motors. The Lockwood Company was originally engaged in building small inboard marine motors, from which it turned to outboards. Numerous smaller manufacturers had also commenced operations and were able to persist for only a short time, due either to under-capitalization or their inability to produce a successful competitive motor under practical producing conditions. At one time in the period prior to 1928 there were about twenty such small manufacturers.

Production had also sprung up in various foreign countries. England was making the Watermota, the Roness and the Coventry-Victor motors, and Sweden was manufacturing the Penta and the Archimedes. Foreign motors have not as yet prevented a large volume of American export business, as the foreign manufacturers seem unable to produce as cheaply as do the Americans. In fact, so dominant is our foreign trade mastery that the export business in the last few years has represented approximately 25 per cent. of the total annual production.

While no exact statistics are available, the following production figures are submitted as an approximation for the period of 1910 to 1930, as compiled from the best data available:

Year	Number of Motors Produced
1910	2,000
1911	4,500
1912	13,000
1913	12,000
1914	10,000
1915	8,000
1916	8,000
1917	7,000

Year	Number of Motors Produced
1918	500
1919	10,000
1920	12,500
1921	14,000
1922	18,000
1923	22,000
1924	30,000
1925	35,000
1926	40,000
1927	45,000
1928	52,500
1929	60,000
1930	50,000
Total	454,000

The decline in production from 1913 to 1917 was due to the world war, and the small production in 1918 was occasioned by the utilization of the plant facilities for war work, upon the entrance of the United States into the war. It is expected that 1931 production will be found to have been somewhat less than the 1930 figure because of current economic conditions.

In January, 1929, a merger was effected by three of the larger competing manufacturers whereby the Evinrude, Elto and Lockwood companies were consolidated under the name of Outboard Motors Corporation, with its plant at Milwaukee. This resulted in the domination of the industry by two large manufacturers, namely the Outboard Motors Corporation and the Johnson Motor Company at Waukegan, Illinois. There are still three or four smaller manufacturers, of which the largest is the Caille Motor Company. The two principal companies are responsible for an estimated percentage of the total American production of 75 to 80 per cent., and maintain this status by vigorous and consistent distribution policies.

The motors now being produced range from one to four cylinders, and are still entirely of the two-cycle type, although there has been considerable experimenting with four-cycle motors. They range in weight from 26 lbs. to 125 lbs. and develop from 2½ to 55 h.p. at high engine speeds.

Some of the manufacturers are at present marketing complete units of boats and motors under their own names, although the boats are not generally manufactured by the motor companies, but are purchased from certain boat manufacturers. Others, on the contrary, confine their sales efforts to motors only, presumably for the purpose of retaining the goodwill of all the boat manufacturers. To the observer, it would seem that the marketing of boats adds one more hazard to those already assumed by the manufacturer, if for no other reason than that boats are subject to quick changes of style and physical depreciation.

The present uses of the motor are quite varied, and the range of models covers every possible purpose. While it is undoubtedly true that they are still utilized principally for sports, such as racing, cruising, fishing, aquaplaning, etc., the commercial purposes can not be minimized. Their primary commercial use is the transportation of passengers and freight, but there is also a large sales outlet among commercial fishermen, hunters and trappers, forest rangers, explorers, traders and others whose vocations render water travel necessary.

The principal advantage claimed for outboard motors on boats of all types is their portability. They can be quickly transferred from one craft to another and are easily transported to any body of water. Boats so equipped can readily traverse shallow waters, for, upon encountering an obstruction, the propeller merely tilts out of harms' way, which is a characteristic not possessed by the rigid drive shaft and propeller of the inboard motor. The inboard motor has the additional disadvantage of usually occupying a large amount of space in the center of the boat, while the outboard is hung at the stern completely out of the way, and permits greater utilization of the carrying capacity.

The industry directly employs at present about twenty-five hundred to three thousand people at the height of the production season, and probably about two thousand on an average for the year. This, of course, is without considering the number of persons employed by the distributors and dealers.

The sales volume in dollars from the inception of the industry up to the present time reached its peak in the year 1929, when the production and sale of about 60,000 motors resulted in a sales total somewhat in excess of $10,000,000.

Manufacturing and Production

Inasmuch as the manufacturing and production methods of the principal manufacturers are quite similar, the discussion of this phase of the outboard-motor industry presented in the following paragraphs may be considered to be representative of the industry as a whole.

The principal raw material entering into the construction of the motors is aluminum. The fly-wheel, crank-case, drive shaft housing, gasoline tank and mounting bracket are entirely aluminum, while the cylinders and crank-shaft are of grey iron. These items are the major parts, and in every instance are received rough cast from the commercial foundries. At the present time, no manufacturer operates an aluminum, grey-iron or brass foundry, probably because the castings are small and the principal manufacturing cost is in the machining, finishing and assembling operations.

The factory operations on the aluminum parts are machining and finishing, which include cutting, boring, grinding, plating and polishing. All such parts are also heat-treated for resistance to salt water corrosion and for high tensile strength. Important additional operations on the fly-wheel, piston and connecting rods and crank-shaft are the balancing of these parts, previously mentioned as essential to the elimination of vibration.

The grey-iron cylinders are bored, turned, ground and honed; in most instances with machines especially designed for the particular operation, and the other miscellaneous parts are likewise treated in the routine manner.

Smaller parts and assembled units, which are generally purchased from independent manufacturers, are the coils, timer, carburetor, piston-rings, spark-plugs, wiring and batteries, ball and roller bearings. The latter type of bearings is used throughout on the high-speed model motors.

At this juncture it is interesting to note that the year 1930 witnessed the application of the electric self-starter to the outboard motor, and this innovation, vigorously advertised, served as a powerful stimulus to sales appeal. As in the instance of the automobile, the self-starter immediately broadened the scope of the potential operators of outboards to include women and children, with resultant increases in sales. Previously, of course, it had been necessary to start the motors by manually revolving the fly-wheel, either by means of a small handle on the fly-wheel or by means of a rope which was wound around the fly-wheel and then suddenly pulled. In 1931 the inertia airplane type self-starter was introduced on certain outboard models and instantly won widespread favor. These starters have an advantage over the electrical self-starter in that it is not necessary to carry and service a heavy-duty storage battery for their operation, and hence their introduction further stimulated the sales field to include remote and rural regions where electric current for recharging purposes is not available. Both of these types of self-starters are purchased as units from independent manufacturers.

Every motor, after leaving the final assembly line, is transferred to the testing rooms, where it is subjected to various preliminary tests in water tanks under conditions which approximate running conditions in open water. Thereafter it is transferred to the final test room and is subjected to various additional tests in test tanks. In addition to these tests, one motor selected at random from every 25 motors coming out of the final test room is given a thorough test under actual conditions on a river or lake. From the final test room the motors go to the packing room for boxing and crating, and then are stored in the finished stock warehouse preparatory to shipment.

Piece-work rates, as established by time studies, permit in paying productive labor on all production orders for both motors and parts, except on the final assembly line, where an hourly rate is used. Hourly rates are also used on orders to replenish the inventory with parts for old model motors, as these parts are produced in limited quantities only, and production is insufficient to justify the use of piece-work rates.

An extensive engineering and experimental laboratory is maintained, where improvements are constantly being developed, and here again a close parallel may be drawn to the automobile industry, for the development of innovations and refinements is required to maintain consumer interest.

As might readily be surmised, the business is highly seasonal. The principal selling season is from May to August, inclusive. A conservative estimate is made of the next year's probable production requirements after the close of each selling season, and actual factory operations are commenced generally in December, on a basis considerably below capacity, continuing on that basis through January, February, March and April to provide sufficient finished motors for the beginning of the selling season. With production during the selling season at about plant capacity, it is expected that enough motors will be produced to take care of the orders during the four heaviest months of the selling season. If sales are heavier than anticipated, reasonable efforts are made to step up production. If the contrary occurs, as it did in 1930 when orders dropped off very sharply in July after an especially good beginning in the earlier part of the year, the manufacturer finds himself carrying over a substantial part of his inventory to the next year's selling season.

The usual procedure is to close the factories, so far as active production is concerned, from August to December. Such orders as may filter in for new motors or replacement parts are filled from stock, and even the office force is sharply curtailed during this period. Superficial consideration would seem to disclose a considerable loss in return on plant and machinery investment during these months of inactivity, and if it were possible to manufacture and distribute an allied class of small gasoline motors for other uses, this loss might be turned into a substantial profit. In any event, the industry offers a fertile field for the application of intelligent thought on the forecasting of economic trends and the development of sound diversification. Perhaps a bit of luck in anticipating future trends would be as desirable in this industry as in most others.

Distribution

Distribution in the early days of the industry was accomplished principally through local agents. At the present time, distribution follows more closely the methods of the automobile industry. Responsible distributors in important territories are given contracts, and the development of smaller agencies is left entirely to them. Shipments to distributors are usually made with sight draft accompanying, so there is no great credit-control problem.

The consumer's market is, of course, limited to territories where bodies of water are near, and this gives rise to a rather peculiar problem in the organization of advertising expenditures. The great arid territories in the west are manifestly sterile fields for sales promotion, although in late years an effort has been made to overcome this factor by the development of light weight motors which are readily portable and require little space. This, together with the growing proclivity of the American public to travel long distances in automobiles for recreation, may still further broaden the sales field. There has also been a marked tendency to increase the "eye appeal" of the newer motors. This is, doubtless, an outgrowth of the modern trend in business to make objects of utilitarian nature as attractive as possible. Accordingly, with the liberal use of chromium plating and attention to neat, compact structure, the new outboard motor is a pleasing object to the eye, and sales resistance has been thereby diminished.

A great deal of attention is devoted to the usual methods of national advertising, including advertising in the leading motor-boat periodicals, outdoor sports periodicals, weekly magazines of large circulation and outdoor posters and bulletins. Additional publicity is obtained through the large number of outboard races held by various regional clubs and associations. Great numbers of circulars, leaflets and brochures are regularly sent through the mails to carefully selected lists of possible users.

Accounting Control

In considering accounting control, it may be of interest to know that one of the principal manufacturers in this industry has applied tabulating machinery, or so-called punched-hole-card accounting, to the control of its cost and general accounting records to probably a greater extent than most manufacturers using such equipment.

Punched-hole cards are used to control production order movements, inventories of materials and finished products, payrolls, accounts receivable, accounts payable, sales analysis, purchase analysis and accumulation of cost figures, and as the same accounting-control problems confront every manufacturer in this industry as well as in most others, a review of the methods employed by this manufacturer may prove of interest, to show the possibilities in the application of this type of control. Without going into the question of whether the method of accumulating cost figures used by this manufacturer is fundamentally correct or whether a different method would better serve the purpose, an attempt will be made to show its actual application in this plant.

It is perhaps a pardonable assumption that most readers of this treatise are reasonably familiar with tabulating machinery equipment, but for the uninitiate a brief explanation may not be amiss.

Punched-hole cards are used as a means of quickly accumulating any required accounting data. The holes are punched in the designated places on the card to indicate various data, and by means of electrical contact made through the holes in the card when they are run through the tabulating machine, these data are accumulated, totaled and printed by the machine, which operates entirely automatically. As an example the material-requisition card may be considered. The required information is punched on the cards by the card-punching machine, operated by a girl. Thereupon all the punched cards for an accounting period dealing with material requisitions are run through the sorting machine, which automatically sorts the cards by production-order numbers. When the cards are so assorted, they are run through the tabulating computing machine, which, also automatically, adds the total of charges in dollars on each production-order number and likewise prints the production-order number and total charge on a sheet of paper preparatory to posting to the record of work in process on motors and parts. Similarly the cards are sorted and totaled by material numbers for posting to the perpetual-inventory record of material and parts in the stock-room. These operations, with necessary variations, are repeated in the accounting control of payrolls, sales, purchases, etc.

The equipment must necessarily consist of at least a hole-punching machine, a sorting machine and a tabulating computing machine. The volume of work to be done determines the number of each type of machine required. The manufacturer whose operations are being considered uses several punching machines, one sorter and one tabulator, and, in addition, one duplicating machine which automatically duplicates any punched card.

Production and inventory control.

Material is requisitioned out of stores through the use of the punched-hole material-requisition card. The requisitions are classified as motor orders and stock orders. The latter are orders to produce finished parts for the stock-room. A motor-production order is prepared by the production department, that department determines the number and model of motors to be produced and issues a separate requisition, filled out in pencil, for every different part entering into the construction of the motor. These requisitions are sent to the stock-room and the numbers of parts called for by the requisitions are accumulated and sent to the sub-assembly department indicated by the requisition. The cards are then returned to the tabulating department, after the number of parts remaining in stock after filling the requisition has been noted.

The tabulating department punches the cards to reflect the data written on them, sorts them by order and assembly-line number, and the total of the charges to each production order is accumulated by the tabulating machine. The totals so accumulated are then posted as charges to work-in-process under the appropriate production order number and credited to finished-parts stores account. This posting is done manually to the perpetual-inventory records. There are about fifteen ledgers and more than 5,000 accounts representing stores inventory, as the manufacturer at present makes three classes of motors, of 20 distinct models, and it is necessary to carry thousands of parts. If the three classes could be consolidated into one, and the number of parts reduced proportionately, it is quite probable that the posting of the stores-inventory accounts could also be done expeditiously through the use of the tabulating machine.

A punched-hole "move ticket" is used to control all the movements of materials returned to vendors, parts returned to store-room from assembly lines, motors delivered from the final assembly line to finished stock warehouse and motors out of finished stock warehouse to customers on sales orders. The accumulation of the accounting data follows much the same procedure as that for material requisitions.

Inventories in the store-room and in the finished stock warehouse are physically test-checked periodically with the stores ledgers—this in addition to the fact that every filled material requisition coming to the stores ledger keeper has noted on it the number of parts remaining on hand in the store-room, which is checked currently with the figure shown by the stores ledger.

Wage and payroll procedure.

For the purpose of controlling payrolls, a punched-hole time-ticket is used. Such a time ticket is prepared for every production-order number on which an employee expends time each day. The ticket is dated with the time of starting and finishing each order on a departmental time-clock. Each ticket shows the number and name of the employee, the production order and the line assembly number, department number, and the operation and machine number, together with the number of parts completed. At the close of the day the tickets are sent to the payroll department, and the elapsed time, the number of parts completed, and the hourly or piecework rate is inserted on each ticket and the amount payable in dollars is computed on a calculating machine.

The cards are then punched to record this payroll information and at the close of the payroll period are sorted by employees and run through the tabulator to accumulate the earnings of each, from which the payroll cheques are prepared. They are then resorted by order number and at the close of the month are again run through the tabulator to accumulate the total of charges to each production-order number for the purpose of determining, (1) the productive labor costs to be charged to each production order, (2) the non-productive labor by departments and (3) the general non-productive labor which is not distributable by departments.

At the close of the payroll period the earnings of each employee, as accumulated by the tabulating machine, are punched upon a bank cheque, the name of the employee is inserted by addressograph plate, and the amount of the cheque is inserted by a cheque-writer in protectograph form. The punched-hole payroll cheque is resorted at the close of the year with the aid of the sorting machine in the order of employee numbers, and the total annual earnings of each employee are thus accumulated with the tabulating machine for the purpose of reporting wages earned to the state and federal income-tax departments.

The punched-hole bank cheques are also found to be of material assistance in sorting and totaling by the machine for the purpose of reconciling bank accounts at the close of each month.

Ordinary "in and out" clock cards are also used, and represent a check on the daily time of each employee against the time shown by his time ticket.

Accounts receivable.

The accounts receivable are controlled through the use of the punched-hole card. Such a card is punched for every sales invoice rendered and for every credit memorandum issued and cash payment made. The cards are kept in the order of the customers' account numbers, and, when invoices are fully paid, the charge and corresponding credit cards are removed from the current file. In addition, an ordinary accounts-receivable ledger account for every customer is maintained. It is posted by the tabulating machine from the punched cards. This latter record gives a better view of the company's debtors and the amounts owed by each. A trial balance of the charges and credits represented in the current file of punched cards run by the tabulating machine is compared with an adding machine trial balance of the posted customers' accounts receivable and with the general ledger control account, for the purpose of proving and balancing.

Inasmuch as the greater part of the shipments are made with demand draft attached, it is obvious that most of the charges are offset by credits within a short time, and the uncollected invoices do not assume large proportions, nor are there many part payments of accounts which would necessitate numerous punched-hole credit cards in the current file.

Sales analysis.

For each invoice rendered a card is also punched for the purpose of sales analysis. The sales classification is simple, as the sales of motors are grouped by motor classes, of which there are six, viz., A, B, C, D, E and F, in each of the three classes of motors. The motors are classed according to the number of cubic inches of piston displacement, under rules set forth by the leading power-boat associations. No classification is made of sales other than motor sales, except to divide them as between parts and accessories and repairs. The classification cards are accumulated for the month, run through the sorter and tabulator, and the total sales computed as classified for the month are turned over to the bookkeeper for entry on the general books.

Information respecting states and countries to which shipments are made, distributors and dealers, etc., is also punched on the cards for the purpose of easily accumulating this desirable statistical information.

Accounts payable.

The accounts payable are likewise maintained on punched cards. Purchase invoices, after being approved, are recorded on punched cards. Cash payments and other deductions are so recorded also. These cards are then kept in the order number of the accounts of the respective vendors and represent the accounts-payable ledger. Bank cheques are immediately drawn in payment of the invoices, though they need not be sent out to the creditors immediately. Such unreleased bank cheques become a visible record of the accounts payable, and a trial balance of the cheques is compared with a trial balance of the punched-hole cards and with the general ledger control account.

Purchase distribution.

A punched-hole card is used in distributing purchases to the proper account. The cards are punched, and the distribution is controlled by the amount of the purchases recorded. The distribution provides for the account number of the vendor, for the production-order number when the items purchased go directly to the assembly line, for the material number where the purchases go to the material stores, and for other account numbers where the purchases represent anything other than material costs, together with the amount in dollars of the purchase. The cards are accumulated for the month, sorted and totaled by ledger account number by the tabulating machine, furnishing the general ledger keeper and the perpetual-inventory record keeper with the total purchase distribution for the month. Statistical information, such as quantities and sources of material and parts purchased, can also be easily procured from the data punched on the cards.

Accumulation of cost data.

The previous comment on production and inventory control indicates how the material costs are accumulated by order number in work-in-process and parts stores inventory account, and the comment regarding payroll procedure is indicative of the accumulation of the productive labor costs in these accounts. It is probably also desirable to consider the basis of distributing the burden in finding the final production-order costs. This is done by charging to work-in-process in respect of each number a certain predetermined percentage of burden for each unit of productive labor-hour in each department. The percentages to be charged are based on prior years' experience under normal operating conditions and naturally vary substantially between departments, because the work in some consists almost entirely of productive labor, with only a limited amount of equipment and space in use, while others employ a large amount of non-productive labor and a comparatively greater amount of space and equipment.

The burden charge per productive hour is noted on the regular payroll time ticket and the total burden charge for each time ticket punched on that card in a space provided for it. The cards are then sorted and the burden charges accumulated by order numbers on the tabulating machine. The total burden so determined is then charged on the books of account to work-in-process and credited to "burden variations" account, against which the actual expenditures for burden expenses are charged. The resulting difference represents burden variations. Thus the work-in-process accounts accumulate the material, direct labor and burden costs by production-order numbers, both for motor production orders and for parts stock production orders, and the total production-order cost and cost per unit are determined. Where a production order provides for enough completed units to make the cost per unit representative, the perpetual-inventory record of unit costs of the same model motor on previous orders is changed to agree with the latest cost, in place of using an average of the various costs.

On account of the seasonal nature of production, there is a substantial amount of actual burden which is not absorbed in the cost figures during the months of January, February, March and April, when a minimum of productive labor is employed. Peak production operations of May, June, July and August should, under normal conditions, result in a large over-absorption of burden in the production costs, with the result that the burden variations will gradually approach a balance as the burden charges for the period from September to December are absorbed. In the latter period productive labor is again at a minimum.

Departmental burden distribution.

Certain actual burden expenses are distributed departmentally. These expenses are non-productive labor, watchmen and janitors' salaries, supplies, depreciation, repairs and maintenance, small tools, dies and fixtures, heat, light and power, gas and water.

Non-productive labor is charged directly to the respective departments from the time tickets. Supplies are charged directly from requisitions. Depreciation of buildings is charged on a relative-area basis, while depreciation of machinery and equipment is charged on the basis of the value and depreciation of such equipment in each department. Repairs and maintenance charges and tools, dies and fixtures are usually charged direct to each department. Heat, light and watchmen and janitors' salaries are charged departmentally on an area basis. Power is distributed by the approximate power load necessary in each department.

All other burden expenses are charged to appropriately named accounts under the general classification of "general undistributed factory burden."

General accounting records.

Any comment regarding the general accounting records or the set-up of the financial balance-sheet appears unnecessary, as the accounts entering into the assets and liabilities are few and simple. The previous comments on cost data indicate that the cost control accounts are tied up and controlled by the general ledger accounts.

The installation of internal audit check in the handling of cash receipts and disbursements, purchases and inventories presents no particular difficulties. The duplicate records of accounts receivable and accounts payable, one in the general accounting department and one in the tabulating machine department, result in an additional control and safeguard not generally found in manufacturing plants.

All the operating expenses are forecast monthly by carefully prepared budgeting of the expenses. A financial budget of collections and borrowings is also prepared for the purpose of controlling the liquid capital as far as possible. Standard ideal cost estimates are prepared for each production order, and variations from such a standard are carefully investigated.

When viewed as a whole the accounting control practices in this case are highly illustrative of the efficient organization in plant and office administration. The outboard-motor industry has enjoyed the advantage which accrues to all new industries, namely, the freedom from old encumbering practices and the untrammeled power to follow modern and scientific lines.

Appreciation and Dividends

By L. L. Briggs

Although American and English court decisions on the subject date back for more than a quarter of a century, the legal status of appreciation of a corporation's assets as a source of dividends was not brought to the attention of the general public until 1928 and 1929 when many investment trusts were considering the declaration of dividends on the basis of increases in value of their securities, which had resulted from the long upward trend in the stock market. Since the treatment of appreciation is an important unsettled point in the determination of surplus available for dividends I have thought it worth while to bring together the leading court decisions and the few statutes that have a bearing on the subject.

The courts of England and the United States have been uniform in holding that realized appreciation resulting from the sale of fixed assets is surplus which is available for dividends. First let us review a few of the English decisions. In an early case, *Robinson* v. *Ashton* (1875) 20 Eq. 28, the issue before the court was whether or not a partner was entitled to half of the profit arising from the sale of a mill. Sir George Jessel, master of the rolls, held that as there was no special agreement, the mill was an asset of the partnership, and, since the selling price was in excess of the book value, the difference was profit and was divisible between the partners in their profit-and-loss sharing ratio. In *Lubbock* v. *British Bank of South America* (1892) 2 Ch. 198, the court decided that profit realized on the sale of a bank building was a proper source of dividends. According to the court in *Foster* v. *New Trinidad Lake Asphalte Company* (1901) 1 Ch. 208:

> ". . . an appreciation in total value of capital assets, if duly realized by sale or getting in of some portion of such assets, may, in a proper case, be treated as available for purposes of dividend."

One of the late decisions is that of *Cross* v. *Imperial Continental Gas Association* (1923) L. R. 2 Ch. Div. 553. In this case the defendant sold corporation property at an increase of about \$7,500,000 over book value, out of which it was proposed to pay a dividend amounting to approximately \$1,000,000. The debenture stockholders objected on the ground that the statute prohibited dividends from capital gains. The court held that the dividends were legal.

Now, let us consider the American cases in point. In *People* v. *Sohmer* (1913) 143 N. Y. S. 313, a corporation leased a building for $200,000. Later, when the property became more valuable, the company sold the lease for $1,050,000 and paid $850,000 to its stockholders in dividends. In his opinion, Justice Lyon said:

> "The sum $850,000 was no part of the capital but was the product of capital. It was derived from an increase in the value of the assets of the company. It represented the profits of the realtor upon its lease, and its division among the stockholders constituted a dividend from surplus profits."

People ex rel Queen's County Water Company v. *Travis* (1916) 171 App. Div. (N. Y.) 521 is a case in which a water company purchased land that it subsequently sold at a profit and distributed this gain as a dividend. The court held that the realized capital appreciation was available for such a purpose and said:

> " . . . It is immaterial, therefore, whether the water company made these profits by selling water or selling land."

In *Equitable Life Assurance Society* v. *Union Pacific Railroad Company* (1914) 212 N. Y. 360, the defendant company had made a profit of more than $58,000,000 by the purchase and sale of stock of another corporation and had declared a dividend partly upon the basis of this profit. A holder of preferred stock attempted to restrain payment of the dividend. Justice Hiscock said:

> "Ordinarily the profits made by a corporation on the purchase and sale of property would so clearly belong to a fund applicable to the payment of dividends that there would be no debate about it. . . . I think it is abundantly established by decisions which are in conformity with and fortified by commercial understanding and experience that the gains or profits realized by a corporation at least from its active transactions such as those under consideration here constitute profits and surplus which are available for dividends."

According to *7 Ruling Case Law*, section 261:

> "An appreciation in value of assets may be taken into account in determining whether or not a profit has been made, and may be distributed as dividends in the same manner as profits arising from earnings, where such appreciation has been actually realized."

Although there is considerable confusion among the decisions on the subject, most of the courts of the United States have held that unrealized appreciation of asset values is not available for dividends. In *Jennery* v. *Olmstead* (1885) 36 Hun. 536, the issue was whether a savings bank had made a profit from which the salary of the president could be paid. The president contended that the difference between the purchase price and market value of certain government bonds then owned by the bank should be called profits. Justice Peckham answered the contention in this way:

"It is not a proper way to ascertain the fact of profits to estimate the value of bonds yet unsold and upon finding the estimated value to exceed the price paid, to call the difference profits. It is not profits in any true sense of that term. If the bonds were actually sold at such price, the transaction would then be completed and the profits actually realized instead of merely estimated. . . . It is claimed that the profits are substantially realized by this appreciation in the value of government bonds, if the bonds are unsold, just as much as if they were sold. If unsold, it is said that the value of the bond is as well known by a simple reference to the reports of the stock market as it would be by an actual sale, and that if sold, all that is got in exchange is another article, whose value may also fluctuate from time to time, and hence there is no sense in demanding an actual sale of the bond before asserting a realization of a profit. Nevertheless the bond unsold is only worth so many dollars, according to the market price thereof, whereas the bond when sold has actually brought so many dollars, and the dollars are in money, made so by law, and that money is now on hand."

In *Kingston* v. *Home Life Insurance Company* (1917) 11 Del. Ch. 258, it was held that surplus resulting from the estimated appreciation in the value of land purchased with corporate capital was not available for dividend purposes. The directors revalued part of the company's property and added $15,000 to a building account with a corresponding credit to surplus. In his opinion, the chancellor said:

"Some things seem clear even to me, and one is that an estimated increase in the value of the building owned by the insurance company and occupied by its officers and employees, however accurately the increase be estimated, is not a net profit arising from the business of the company. If it is an investment of capital of the company its increased value when realized by a sale may perhaps be treated as a profit but until realized it is surely unwise, inaccurate and wrong to so regard it and pay out money based on such an estimate, for it is only a guess, and if a correct one it may become incorrect later when the conditions which produced the estimated increase of value change."

Hill v. *International Products Company* (1925) 220 N. Y. S. 711 is a case in which the company paid a dividend based upon surplus resulting from an estimated increase in the size and weight of cattle owned by a department of the corporation. Justice Mahoney said:

"It would seem to me that this alleged in value of cattle not realized by an actual sale of cattle is not a proper item to be taken into consideration in determining the actual surplus of a going concern."

In *Wilson* v. *Barnett*, a case reported in New York "Law Journal" of August 2, 1928, corporate directors declared a preferred stock dividend from surplus which came from a reappraisal of an old hotel site. The receiver of the company sued the directors and the court held them personally liable for the amount of the dividend. Justice Baugh, in *Dealers' Granite Corporation* v. *Faubion* (1929) 18 S. W. (2d) 737, stated the principle in these words:

" . . . And the general rule seems to be that increase in the value of lands held by a corporation cannot be considered profits, at least until such lands are sold and the profits actually realized."

In *Southern California Home Builders* v. *Young* (1920) 188 P. 585, the directors paid three dividends on the basis of statements prepared by bookkeepers of the company, appraisals of corporation property, and the certificate of a certified public accountant. The plaintiff brought an action against the directors of the corporation on the ground that the appraisal value was inflated and that, as a result, the dividends were not legitimate since they were from capital. Justice Brittain, in giving judgment for the plaintiff, made the following statement:

"Mere advance in value of property prior to its sale or estimated profits on partially executed contracts, do not constitute profits, because the fluctuations of the market . . . may bring about a condition such as was found in the present case where the estimated profits were in fact liabilities or direct losses."

Marks v. *Monroe County Permanent Savings and Loan Association* (1889) 22 N. Y. S. 589 is a case in which the defendant association lent money to its members on bond and mortgage. The member would give a mortgage for a certain amount and would receive that amount less discount at a given per cent. for the time specified in the contract. An example given in the case was that of the association paying a borrower $495 cash for a mortgage of $525. The issue before the court was whether the discount was available for dividends. In his opinion, Justice Ramsey said:

". . . But I do not think the profit can be said to be earned until the transaction is closed and the money is in the treasury. Until that is done there may be no profits. The failure to pay may make the asset worthless. This distinction between the gain by the appreciation in value of an asset, and the final gain of money in hand by its sale at an enhanced value, is taken and made the rule of the decision in *Jennery* v. *Olmstead*. . . . I think the holding of the court in that case, that profits are not realized because the value of the assets is enhanced, is controlling here against the plaintiff."

In *Moore* v. *Murchison* (1915) 226 Fed. 679, Mrs. Moore paid $7,800 for assets that were inventoried at more than $15,000. A corporation was organized and Mrs. Moore turned these assets over to it for 78 shares of common stock with a par value of $100 a share. The directors entered the assets on the books at their face value, thereby creating a surplus from which they declared a dividend. The company later became bankrupt and the trustees sued the directors. The court held them personally liable for the full amount of the dividends. According to the facts of *Hastings v. International Paper Company*, 187 App. Div. (N. Y.) 404, the inventoried goods of the defendant corporation had increased in value during the previous two years and these assets had been placed on the balance-sheet at the appreciated value. In regard to this appreciation, the court said:

> "This sum of $18,869,666.88 does not represent actual profits, as the materials have not been turned into money. Moreover, the apparent large profits may pass into the air on a falling market."

In *Coleman* v. *Booth* (1916) 268 Mo. 64, the company wrote up the value of its goodwill in order to show a surplus against which a dividend might be declared and justified the reappraisal on the ground of the corporation's high earning power. The court condemned this procedure and held the directors liable for the dividends declared. The court apparently thought that the increase in goodwill as indicated by the write-up did not exist.

Next, let us review cases in which unrealized appreciation of assets apparently has been sanctioned as a source of dividend. *Hutchinson* v. *Curtis* (1904) 92 N. Y. S. 70 is a case involving the American Malting Company, which bought barley by a bushel of 48 pounds for the purpose of making malt that was sold by bushel of 34 pounds. The process of manufacture produced about 15 per cent. more of malt by the bushel than the barley measure of the raw product. This increase was added to the inventory and credited to surplus to be used as a basis for quarterly dividends to the preferred stockholders. In his opinion, Justice Clarke said:

> ". . . Of course, this increase has a value as it is sold as malt at malt prices. For the purpose of inventory, the company has ascribed to it the value of the barley. This, plaintiffs claim, is error, because that amount has already once been charged to the malt account, and they say that this increase should have no value ascribed to it until sold and delivered, when its proceeds go into the books as cash. But it certainly is an asset of the company, and as an asset at inventory periods, or when it is necessary to ascertain the actual condition of the company, it must be valued in some way. As it has always been the custom in the malting business to treat it as treated by this company, I am unwilling to disregard that custom . . ."

In *Splittgerber Brothers* v. *Skinner Packing Company* (1930) 228 S. W. 531, the defendant corporation having learned that real estate which cost $98,661.67 was valued at $372,779.55 by an appraisal company, added the increase to the asset account, credited it to surplus and declared dividends from such surplus. The increase in value was approved by the lower court. Although the upper court reversed the decision on other grounds it apparently considered the surplus based upon the revaluation to be a legitimate source of dividends if the appraisal was bona fide. District Judge Raper approvingly quoted 14 *Corpus Juris* 804 in the following words:

"If the assets of a corporation are valued honestly and fairly in view of all the facts known at the time of the declaration, a dividend is not rendered unlawful by the fact that such assets subsequently prove to be worth less than the valuation placed upon them."

In *Privat* v. *Grand Bay Land Company* (1919) 41 S. D. 494, the defendant corporation was organized in South Dakota for the purpose of buying and selling land in Alabama. It purchased large tracts, cut them up into small tracts and sold them to people in the north. The company claimed the right to declare dividends when its assets exceeded its liabilities, and in estimating its assets it included unsold lands at market value on the dividend date, regardless of the cost price. In an action against the corporation to recover dividends paid from such unrealized appreciation, the lower court gave judgment for the defendant and this was affirmed by the supreme court of South Dakota.

Since a stock dividend takes nothing from the business, the legal objection to cash dividends from unrealized appreciation does not apply to it. *Berwind-White Mining Company* v. *Ewart* (1895) 32 N. Y. S. 716, involved a suit by a stockholder to enjoin a stock dividend which apparently was based upon unrealized appreciation. The court refused to grant the requested injunction. In *McGinnis* v. *O'Connor* (1909) 72 A. 614, the stockholders of a corporation having a capital stock of $15,000 agreed that the plant and goodwill were worth at least $25,000. In a dictum, Justice Worthington stated that the increase of $10,000 could be treated as profits for the basis of a stock dividend in the reorganization of the company.

In *Northern Bank and Trust Company* v. *Day* (1915) 83 Wash. 296, the Standard Fish Company paid $22,500 for a boat and entered it on the books at $15,000. Later it was decided to raise the book value of the asset to $20,000 to create a $5,000 surplus which was added to an earned surplus of $10,000 and this amount was made the basis of a $15,000 stock dividend. In an action by the trustee in bankruptcy against a stockholder to recover the dividends paid, the court decided in favor of the defendant. *State* v. *Bray* (1929) 20 S. W. (2d) 56, is a case in which the defendant corporation increased its capitalization and paid a large stock dividend based upon appreciation of real estate and other fixed assets. In an action against the corporation by the state of Missouri to declare the charter forfeited on the ground of an illegal issue of stock, the defendant was able to prove that the appreciated value of the assets in question was not greater than the replacement value and thereby won the case.

Stock dividends from unrealized appreciation of assets are expressly authorized by the uniform business corporation act which has been adopted by Ohio and Idaho. The reasoning of the Ohio State Bar Association committee on corporation law on this point follows:

> "A corporation should never write up its assets on account of some fancied or estimated unrealized appreciation in value of assets in order to clear a deficit from its balance-sheet or to create a surplus to enable it to pay dividends for the reason that shareholders and the public may thereby be misled, but if such action is taken in the open and an honest redetermination of the value to the corporation of its assets is made in the manner in which a determination of such value would be made if shares were being issued for considerations other than cash, no one can possibly be injured for the reason that an equivalent result could be accomplished by the organization of a new corporation and the sale of entire assets to such new corporation."

Alabama also has a statute which makes this class of appreciation available for stock dividends. According to section 6991 of the 1923 code:

> "Before the board of directors of any corporation shall be authorized to declare any such stock dividends, other than on a surplus of money, it shall order the appraisal of all tangible assets of the corporation by a competent appraiser or appraisers."

New York, Vermont, and Wisconsin, the other states that have statutes explicit enough to include or exclude appreciation, make unrealized appreciation a legitimate basis for stock dividend purposes.

So far as I have been able to ascertain, there is no American decision which sanctions the offsetting of depreciation by appreciation. However, there is an English case which has been cited as authority for such action. In *Ammonia Soda Company* v. *Chamberlain* (1918) 1 Ch. 266, the corporation owned soda beds which were becoming exhausted as a result of the company's operations. A depletion reserve account was kept and the books showed a deficit. The soda beds were found to be richer than originally had been suspected. The directors reduced the depletion reserve in order to eliminate the deficit and then declared dividends from subsequent earnings. In an action against the directors, the court held that they were not liable for the distribution of such dividends because the English law did not require the setting aside of a depletion reserve. The court also said that there was no rule of law which prohibited a corporation from setting off appreciation in the value of its capital assets, as determined by an honest valuation, against losses in revenue. This case involves an increase in value due to the discovery of new assets rather than an appreciation in the market value of the same assets. It is doubtful whether this decision is authority for offsetting depreciation in the value of certain assets by appreciation in the value of other property because depletion rather than depreciation is concerned.

Statutes directly or indirectly involving appreciation may be divided into two groups: the general dividend statutes and the statutes explicitly mentioning appreciation. The general dividend statutes may be classified as the balance-sheet group and the surplus-profits group. In the jurisdictions having the first-mentioned type of legislation, dividends may be declared only when the assets exceed the liabilities and the capital stock. In these states, by implication, dividends may be based upon appreciation of assets. The only legitimate source of dividends in the second group of states is surplus profits. Consequently, these states do not permit the declaration of dividends from appreciation unless that appreciation comes within the classification of surplus profits.

Two states have statutes which take a definite stand on the availability of unrealized appreciation for the purpose of cash dividends. The Wisconsin statutes (1925) 182:19 read as follows:

"Any corporation which has invested or may invest its net earnings or income or any part thereof in permanent additions to its property or whose property shall have increased in value, may lawfully declare a dividend payable to stockholders upon its capital either in money or in stock to the extent of the net earnings or income so invested or of the said increase in the value of its property; but the total amount of such dividend shall not exceed the actual cash value of the assets owned by the corporation in excess of its total liabilities, including its capital stock."

According to *112 Laws of Ohio* (1927) Sec. 8623:

"No corporation shall pay dividends in cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, plus stated capital, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets; . . ."

Thus, we see that Wisconsin expressly permits cash dividends from unrealized appreciation of assets for dividend purposes while Ohio clearly prohibits such dividends.

To summarize—the courts are agreed that realized appreciation of corporate assets is available for dividend purposes, but most jurists have held that unrealized appreciation may not be distributed to stockholders in the form of cash dividends. There are a few decisions which apparently are contrary to the general rule but these were decided so as to conform to recognized trade practices or to take cognizance of some circumstance peculiar to the particular case. Stock dividends from unrealized appreciation are expressly legalized by statute in six states and the general dividend statutes of the other jurisdictions probably legalize such dividends by implication. No American decision permits a corporation to offset depreciation by appreciation. The general dividend statutes do not expressly permit cash dividends from appreciation, but it has been said that some of them do so by implication. Wisconsin has a statute which expressly permits cash dividends from unrealized appreciation, while Ohio has a statute which expressly prohibits such dividends.

In closing, it may be said that the general trend of the statutes and the common law in regard to appreciation is to conform to conservative accounting practice by prohibiting cash dividends from unrealized appreciation in the value of corporate assets and by allowing stock dividends to be based upon such appreciation.

Municipal and Other Governmental Audits

By G. E. Klanderman

In recent months there has been a noticeable increase in the number of public accountants engaged in making audits of municipalities and other governmental units. This is largely due, no doubt, to the fact that more municipalities and other governmental units are having audits made than ever before. Another possible reason may be that the period of economic depression has resulted in diminishing revenue from other kinds of public accounting service.

Incidentally, the most widely discussed subject in public-accounting circles today is a condition that has been brought about largely by this increased activity in audits of municipalities and other governmental units. I refer to the matter of competitive bidding. However, I am mentioning this factor incidentally only, as a discussion of that subject is not within the province of this article.

The point that I wish to make is that in view of the prominence being given to audits of municipalities and other governmental units, it certainly behooves all of us to be well informed as to the proper audit procedure for such audits. An exchange of opinion based upon our respective experiences ought to prove beneficial to the profession as a whole, and it was with this thought in mind that the present article has been prepared.

At the outset, it should be remembered that audits of governmental units are, to a large extent, subject to the same fundamental rules of audit procedure as all other audits. These fundamental rules have been well established by eminent authorities as well as by common usage, and no useful purpose would be served by repeating them in an outline of this character. For this reason, the suggested audit procedure here set forth has been limited to what is either peculiarly applicable to an audit of a municipality or other governmental unit or prescribes the amount of detail to be covered.

Audits of municipalities and other governmental units, like other audits, may be broadly divided under two headings: (1) the verification of the assets and liabilities as at the close of the fiscal year, and (2) the verification of the transactions which took place during that year. With this in mind, this outline of audit procedure has likewise been divided into two sections, the first of which is concerned with the verification of the assets and liabilities of the municipality or other governmental unit at the close of its fiscal year, and the second of which is concerned with the verification of fiscal transactions for the year ended on that date.

For convenience and brevity the word "unit" will hereinafter be used in lieu of the words "municipality or other governmental unit."

SECTION I—VERIFICATION OF ASSETS AND LIABILITIES

A glance at the balance-sheet of any unit will at once disclose that some of the assets and liabilities appearing thereon are identical in character with those appearing upon an ordinary commercial balance-sheet. Examples of such items are cash on hand and in banks, investments, inventories of materials and supplies, accounts and notes receivable and payable, etc. The verification of any such assets or liabilities is subject to ordinary rules of audit procedure, and it will be assumed that ordinary procedure will be employed in such cases. The audit procedure outlined by the federal reserve board in its booklet, *Verification of Financial Statements*, is excellent.

The asset item which first comes to mind as being peculiar to a unit is "taxes receivable." For present purposes, the caption "taxes receivable" embraces uncollected taxes of all kinds as at a given date and includes taxes due, past due, and not yet due (such as future instalments of assessments for streets, sewers and other local improvements). The totals of all such uncollected taxes as shown by the balance-sheet of the unit at the close of its fiscal year should be proved by listing the unpaid taxes as shown by the individual tax rolls, tax duplicates or tax-arrears register as the case may be. After thus proving the balance-sheet totals, the individual items should be vouched by mailing verification statements to all taxpayers against whom the books show unpaid taxes at the balance-sheet date.

Before leaving the subject of taxes receivable mention should be made of the fact that in case any tax titles are owned by the unit they should be proved by listing and examining the tax-sale certificates.

Construction in progress, as shown by the balance-sheet of the unit, whether representing improvements to be charged against properties specifically benefited or representing improvements to be paid for by the unit at large, should be checked against the individual construction accounts, which in turn should be analyzed in detail. Inquiry should be made as to the nature of each of the various improvements and as to the status of each improvement at the date of the balance-sheet. Investigation should also be made as to whether the total construction in progress represents merely cash expenditures to date or whether it includes unpaid liabilities as well. The auditor should also determine that all the construction projects have been properly authorized and that the total cost of each does not exceed the maximum expenditure which was authorized.

If the auditor is making his first audit for the unit, the book values of the fixed or capital assets should be investigated to determine the basis upon which the values were set up on the books. In subsequent audits, it is necessary only to verify the annual additions or retirements of the fixed or capital assets as shown by the accounts and as determined by investigation or inquiry. While ordinarily it should not be expected that the auditor verify title to the various properties owned by the unit, this matter should be investigated.

In consideration of "inter-fund accounts," the balances due between funds should be carefully investigated as, in many cases, the withdrawal of cash from one fund for the benefit of another is unwarranted and unlawful.

The verification of accounts payable or vouchers payable is subject to general rules of audit procedure. It should, however, include the taking of trial balances of the subsidiary ledgers and the sending of verification statements to all trade creditors whose accounts show unpaid balances as at the date of the balance-sheet. In addition, verification statements should also be sent to all other trade creditors to whom the unit has been indebted during the three (or more, depending upon the circumstances) months immediately prior to the date of the balance-sheet whose accounts appear to have been closed on that date.

The determination of the existence and extent of the liability of the unit, either direct or contingent, under "construction contracts payable" requires diligent and thorough investigation. First, the auditor should ask for and examine copies of all construction contracts which were entered into by the unit during the year, or were entered into *prior* to the year but were still in force *during* the year (either by reason of uncompleted construction at the beginning of the year or by reason of litigation or controversy). The auditor should then determine—by inquiry, investigation or by communication with the other party or parties to each contract —the amount of the unit's liability, either direct or contingent, under each contract.

Notes payable as shown by the balance-sheet should be verified by communication with the recorded holders of the notes. Communications should likewise be addressed to all depositaries of the unit and also to all parties who (the books of the unit show) accepted the unit's paper during the twelve months' period ended with the balance-sheet date.

In verifying the amount of bonds payable as shown by the balance-sheet, careful investigation should be made in order to ascertain that the outstanding bonded indebtedness of the unit is correctly stated on its books. This investigation should include not only an analysis of the books of account and supporting records, but should also include a scrutiny of the minutes of meetings of the governing body for the current fiscal year and the next prior fiscal year, as well as an investigation of any other available sources of information. One such source is the disbursements which were made during the fiscal year for the retirement of bonds and for the payment of bond interest coupons. A careful analysis of the canceled bonds and bond interest coupons is helpful in determining the outstanding bonded indebtedness.

As a matter of fact, thorough investigation and analysis are necessary in order to ascertain that all liabilities, bonded or otherwise, have been set up on the books of the unit as at the date of the balance-sheet. Ordinary audit procedure should accomplish this.

Deposits, either for public-utility service connections or deposits of any other kind, as shown by the balance-sheet should be checked against the open deposit receipts or other records. Where the receipts issued for such deposits are not rendered upon a special printed form having consecutive numbers, the determination of the liability of the unit in regard to such deposits may require considerable investigation. In the case of deposits for public-utility service connections, it is suggested that the auditor determine, by inquiry or by other means, the number of meters outstanding and use this information in roughly checking the liability of the unit for light or water deposits payable.

In the case of "taxes collected for other units" the verification of the amount of the liability of the unit for such tax collections should include communication with such other unit or units.

In case the unit has in the past issued non-serial bonds requiring the establishment of sinking funds for their retirement, an investigation must be made in order to determine that the sinking funds have been properly maintained.

Cemetery funds should be thoroughly investigated. In case the unit has been making sales of cemetery lots with a guaranty of perpetual care as part consideration for the sales price, the auditor must determine that reserves for perpetual care are being maintained in sufficient amounts to cover the unit's contingent liability in this respect. The amount of unsold cemetery lots carried on the balance-sheet of the unit should be investigated. The auditor should ask for detailed lists of all unsold cemetery lots at the date of the balance-sheet, and the basis for their book value should be investigated.

Trust funds in the custody of the unit should be investigated to ascertain the amount of the unit's liability for such funds and to determine that the unit is separately carrying sufficient assets (usually cash and securities) to meet its obligation under the trusts. Police and firemen's relief or pension funds are common examples of trust funds of a unit.

Section II—Verification of Transactions During Fiscal Year

Revenues and receipts. That part of an audit of a municipality or other governmental unit which differs most from other audits is the verification of revenues and receipts. This is due to the fact that the sources of revenues and receipts of a unit are peculiar to itself and are widely different from the revenues and receipts of ordinary commercial enterprises. For this reason, the major portion of this section is devoted to the verification of revenues and receipts of a unit rather than to its disbursements and expenses, the audit of which is more like ordinary audit procedure.

Taxes. The largest and most important source of revenue of a unit is its taxes. The audit of revenues from taxes can conveniently be considered under three separate headings as follows:

(a) Taxes for current year.
(b) Delinquent taxes for prior years.
(c) Assessments for improvements.

Under section I, of this outline, provision was made for the verification of all uncollected taxes at the close of the unit's fiscal year by listing the outstanding taxes as shown by the tax rolls, tax duplicates or tax-arrears registers on that date. For the purpose of this section of the outline, it is assumed that the amount of uncollected taxes has thus been proved. The following additional steps should be taken in auditing taxes assessed and collected for the current fiscal year.

(*a*) *Taxes for current year.* The original tax roll or tax duplicate for the current year should be added complete and the totals checked against the books and against the minutes of the meeting of the governing body at which the tax roll or tax duplicate was confirmed. The addition of the tax roll should include not only the various tax columns (such as real, personal, poll, dog, bank stock, etc.), but should also include the valuation summary columns. The gross amount of the real and personal property taxes should be roughly checked by applying the authorized tax rate against the total real and personal property valuation.

Reconciliation should then be made between the original amount of the tax roll (or tax duplicates) and the amount uncollected at the close of the year by taking into consideration collections, remissions and cancellations for the year. The total tax collections for the year as shown by the reconciliation should be checked against the totals shown by the cashbooks to see that they are in agreement. The tax remissions and cancellations for the year should be listed and then investigated in detail in order to determine that satisfactory authorization exists for every remission or cancellation.

Test checks should also be made of the collections as shown by the cashbooks by comparing individual paid items appearing upon the tax roll (or tax duplicates) with the cashbooks, noting at the same time if interest and penalties were properly collected and reported.

(*b*) *Taxes for prior years.* As was the case with taxes for current year it will be assumed that the amount of all prior years' taxes which were still uncollected at the close of the fiscal year being audited have already been proved as provided for under section I. If the auditor did not audit the unit for the next preceding year, he should also endeavor to establish and prove the uncollected amount of such prior year's taxes as at the beginning of the fiscal year under audit. This should be done by listing the items which are shown by the tax duplicates or tax-arrears register to have been outstanding at the beginning of the fiscal year and comparing the totals thus determined with the balance-sheet and book figures as at that date.

Reconciliation should then be made between the totals thus established as at the beginning and end of the fiscal year, by accounting for collections, remissions and cancellations—all of which should be checked as provided under the second paragraph of "taxes for current year."

Test checks should likewise be made as provided under the third paragraph of "taxes for current year."

In verifying delinquent taxes which have been sold, the auditor should investigate the revenues from penalties, advertising and expense of holding the tax sale, all or part of which should have been added to the amount of delinquent taxes when each tax sale certificate was issued.

(*c*) *Assessments for improvements.* Assessment rolls for improvements (such as for streets, sewers, sidewalks, etc.) which were spread during the current fiscal year should be added complete and the totals proved with the assessment roll authorizations as contained in the minutes of the governing body. Reconciliation should then be made between the original amount of each assessment roll as thus established and the uncollected amount at the close of the fiscal year. This reconciliation should take into consideration collections, remissions and cancellations, all of which should be checked in the manner explained under "taxes for current year."

In the case of assessment rolls which were spread prior to the fiscal year under audit, the uncollected amount of each roll both at the beginning and end of the fiscal year should be established and proved. Reconciliation should then be made in the manner already explained.

Interest and penalties collected are an important factor of assessment rolls, and in testing the individual tax collections as explained under the heading "taxes for current year," the auditor should particularly note that the proper amount of interest and penalties have been collected.

The auditor should examine the books of the unit and the minutes of the governing body and make inquiry in order to determine exactly what improvements were completed during the fiscal year. He should prepare a list of them. This list should then be checked against the assessment rolls spread during the year, in order to determine that assessment rolls have been properly spread for all improvements completed during the fiscal year which are chargeable against properties specifically benefited. The auditor should also inquire whether or not any improvements were completed prior to the fiscal year for which assessment rolls have not yet been spread.

Income from public utilities operated by the unit. The audit procedure for the verification of the income from public utilities operated by a unit (as well as the verification of the expenses of such utilities) is basically the same as the audit procedure which would be necessary in the case of privately owned public utilities.

A discussion of the audit procedure for public utilities is a subject in itself and has no place in the present article, except by way of reference. One particular phase of the audit of public utilities owned or operated by a unit may, however, be mentioned. It is that the auditor should satisfy himself that none of the revenues or expenditures of the public utility has been improperly charged or credited to other departments of the unit and, conversely, that none of the revenues or expenditures of other departments of the unit has been improperly charged or credited to the public utility.

Income and receipts from miscellaneous sources. Licence, permit, and inspection fees; fees for recording or making copies of deeds, mortgages, and other instruments or certificates; and, in fact, fees of every description collected by the treasurer, clerk or other officers of a unit should all be verified by checking the totals shown by the books against the duplicate copies of the receipts issued for such licence, permit, recording and other fees during the fiscal year.

It is assumed that the receipts are issued upon a printed form with consecutive printed numbers. If such is not the case, the auditor should make such further investigation as he deems necessary in order to satisfy himself that the duplicates of all receipts issued have been presented for his inspection.

As a general test, the auditor should, by investigation or inquiry, satisfy himself that the gross amount of revenue recorded on the books from each individual source for the year is a reasonably sufficient sum to be expected from that particular source.

In any event, the auditor should obtain a complete and accurate schedule of the rates of all licence, permit, inspection, recording and other fees, as provided by statute or ordinance, and then make substantial tests in order to determine that the proper rates of such fees have been collected.

Furthermore, due to the large amount of revenue arising from licence and permit fees, the auditor should scrutinize the schedule of occupations, businesses, acts, etc., for which licences or permits are required and, by investigation or inquiry, satisfy himself to a reasonable degree that the income which should have been collected from the various kinds of businesses, occupations or acts has not escaped the treasury of the unit. While it is realized, of course, that the auditor can not reasonably be expected to know the number of each kind of business, occupation, etc., subject to licence or permit fees within the unit, he should look into the matter and use ordinary diligence.

In the case of plumbing, electrical and other inspections, sewer or water taps, building, sidewalk and other permits, and similar sources of revenue, the auditor should refer to the records or reports made by the various inspectors or other employees of the unit and should make tests to see that the income has been properly accounted for on the books.

Revenues from the sale of materials, services or both (other than from light, water or other public utilities) as shown by the books of the unit should be checked against the duplicates of the invoices rendered. In addition, the auditor should make such further investigation or inquiry as he deems necessary in order to satisfy himself that the duplicate invoices presented for his inspection represent all the sales made during the fiscal year. It is suggested that the auditor refer to any departmental reports or other original sources from which the duplicate invoices were prepared or, if necessary, communicate with department heads and other employees for the purpose of making reasonably sure that there are no missing duplicate invoices. The auditor should also make tests of the accuracy of the extensions and additions of the invoices.

Sales of "services" referred to in the preceding paragraph include the charges made for non-required service rendered by police and fire departments or by sheriffs' offices, such as calls outside their respective jurisdictions or for special protection for private affairs or functions. Another instance that frequently occurs is the employment of prisoners or convicts or the sale of products of their manufacture. The auditor should investigate the amount of revenues from the above sources recorded on the books of the unit and check them against the departmental records.

Revenues from entry and other court fees and from fines and costs imposed by courts or police authorities of the unit, as well as receipts from cash bail deposits and from alimony and other sums collected under court orders, should be checked against the court dockets, court orders or other court records. The matter of forfeited cash bail and of unclaimed alimony and other unclaimed cash collections should be investigated. Refunds made by the clerk of court should be traced to refund orders signed by the court. In the case of amounts collected by traffic bureaus for traffic violations, the income received (usually designated as estreated bail) as shown by the books of the unit should be checked against the records of such bureaus, the bureau records in turn then being scrutinized and tested.

If the unit being audited is entitled to receive grants, subsidies, tax moneys, or like revenues from the state or from another governmental unit, the auditor should determine the amount by an examination of the state statutes, by inquiry, and by communication with the state or governmental unit from which such sums are receivable.

Revenues received from the operation of the various departments of the unit (other than public-utility departments) as shown by the independent records of such departments should be traced into the unit's cashbook. The departmental records themselves should then be audited to whatever extent is necessary for the auditor to satisfy himself as to the sufficiency, if not the absolute accuracy, of the amounts of the recorded revenues. Common examples of independent operating departments of a unit include: abbatoirs, auditoriums, cemeteries, farms, golf courses, hospitals and sanatoriums, public libraries, park concessions, stadiums, wholesale or retail markets and public schools. The sources and kinds of revenues of each of these departments are more or less peculiar to itself and in order to make a proper audit of such departments the auditor must, by inquiry or investigation, thoroughly familiarize himself with the nature and extent of the operations of each department.

Specific mention may be made of the revenues from public schools and cemeteries. The main source of revenue of public schools is usually an apportionment of tax moneys collected by the unit, plus subsidies received from the state. The manner of auditing such sources of revenue has already been mentioned. Another common source of school revenue is tuition from non-resident pupils. In verifying the amount of tuition collected, reference should be made to the pupil-attendance records maintained at the school offices. In addition to the sources of school revenues just mentioned, each particular school may have miscellaneous other receipts from athletic contests, locker rentals, and other sources. In the majority of cases, these miscellaneous receipts are maintained in independent funds in the custody of one or more persons. As a general rule, it is not expected that the scope of the auditor's examination should include these miscellaneous funds, for the reason that the amount involved in each fund does not warrant the amount of time which would be required to audit it. Nevertheless, in order to avoid any subsequent controversy over the matter, the auditor should definitely determine in advance whether or not these miscellaneous funds are to be included in the audit.

The revenues of cemeteries arise mainly from sales of lots, annual care of lots and burial fees. No particular problem arises in the verification of these revenues, with the exception of lot sales, in which the sales price carries with it a guaranty of perpetual care or care for a term of years. In such cases, the auditor should make certain that a proper portion of the sales price of each lot has been transferred to a perpetual-care fund or is held in reserve by means of investments or restricted bank deposits for that purpose.

Income from rents should be checked against rental agreements and a list of all properties or equipments rented by the unit or those that were rented by the unit during the fiscal year should be obtained.

Income from interest on daily bank balances should be checked by examining the agreements made with the depositaries for such interest and by noting the reasonableness of the amounts received as shown by the books. Tests should also be made as to the calculation of the interest.

Income from investments owned by the unit should be completely audited for the entire year. A schedule should be prepared showing the investments owned by the unit at the beginning of the fiscal year and all additions to or deductions from such investments during the year. The income receivable by the unit on each separate investment should then be carefully checked by the records to see that all the income was properly collected and reported. All purchases and sales of investments during the year must be verified.

Receipts from sales of bonds or notes during the fiscal year should be checked against the bond or note authorizations as shown by the minutes of the governing body, and any premiums or accrued interest properly recorded.

Inquiry should be made to determine whether any property owned by the unit and held by it for use, investment or sale was sold or otherwise disposed of during the fiscal year. If so, the proceeds from the sale or other disposition of such property should be fully verified.

In the case of all revenues the receipt of which was anticipated in the current budget of the unit, the auditor should make a detailed comparison between the estimates of revenues included in the budget and the actual receipts as shown by the books of the unit.

Expenses and Disbursements

Although the expenses and disbursements of a unit are widely different both in nature and classification from those of an ordinary commercial enterprise, the verification of such expenses and disbursements of a unit is, nevertheless, similar to their verification in ordinary audits.

Generally speaking, there are five major facts to be ascertained in determining the correctness of the disbursements made by a unit during the fiscal year under audit. These are as follows:

(1) That all disbursements were properly authorized,
(2) That all were properly and sufficiently supported by vouchers,
(3) That all were properly applicable to the period under review,
(4) That the distribution of the charges for all disbursements has been properly made, and
(5) That all were covered by sufficient appropriation made by the governing body of the unit.

In the case of disbursements supported by invoices, the auditor should note that the invoices have been approved, that certification as to the receipt of the goods appears thereon or is attached thereto, and that the extensions and additions are correct. Tests should be made of the prices paid by the unit for standard commodities in order to determine that such prices are not excessive. Note should also be taken of cash discounts in order to determine that the unit is not neglecting to take advantage of discounts.

In the case of disbursements for labor or salaries, the payroll records must be audited. Rates and salaries paid should be noted and approvals requested from responsible officers of the unit. However, where employees or officers are engaged upon an annual salary basis the salaries paid should be compared with the authorized amounts. The matter of unclaimed wages should also be investigated.

In the case of disbursements representing improvements to be charged against property specifically benefited, or disbursements for any other construction not provided for in the current year's budget, the auditor should examine the minutes of the governing body authorizing such improvements or construction and then satisfy himself that the disbursements made and charged against such construction were proper.

In the case of disbursements for the retirement of maturing bonds and bond interest coupons, the auditor should check all such disbursements for the entire year against the canceled bonds and coupons.

Disbursements from petty-cash funds should receive just as careful attention as disbursements by cheque. All petty-cash disbursements for the entire year should be scrutinized and any large, frequent recurring or unusual items investigated. In particular, the auditor should determine that duplicate payments have not been made from both petty-cash funds and by cheque.

In the case of disbursements representing items included in the current budget of the unit, the auditor should also make a detailed comparison between the various budget appropriations and the total expenditures for the year.

The auditor should not, of course, consider his task complete until he has, by sufficient examination, satisfactorily assured himself as to the clerical accuracy of the books. This examination should include the verification of postings and footings, both of the ledgers and books of original entry; the examination of all journal entries; the tracing of recorded cash receipts into the bank; the comparing of recorded cash disbursements with the canceled cheques returned by the banks; the vouching of transfers between banks and transfers between funds; and whatever other steps are necessary.

General

In addition to the audit procedure which has been described, the minutes of the meetings of the governing body of the unit for the fiscal year under audit should be carefully examined and memoranda made of all pertinent items affecting the audit. The statutes should also be reviewed and note taken that they have been properly observed. If the unit is a municipality, the charter granted to it by the state should be examined for the same purpose.

The audit report naturally differs with every individual audit. In addition to any comments or qualifications which the auditor believes necessary in order to support his certificate, his audit report should contain comments as to any shortages, discrepancies or irregularities of any kind which came to his attention or as to any failure on the part of the officers or employees of the unit to comply with requirements prescribed by statute, charter or ordinance. The following is also suggested as being good material to include in the audit report:

1. Balance-sheet, consolidated, of all funds.
2. Balance-sheet for each individual fund.
3. Statements of cash receipts and disbursements for the year, by funds.
4. Statement of current year's revenues, compared in detail with budget estimates.
5. Statement of current year's expenditures, compared in detail with budget appropriations.
6. Operating statements of public utilities.
7. Schedule of investments owned.
8. Schedule of notes payable.
9. Schedule of bonds payable.
10. Schedule of insurance coverage.
11. List of officers of the unit and members of the governing body.

Of course, the extent to which any part of this audit procedure should be followed will depend upon the circumstances in each individual case and must be left to the discretion of the auditor.

Students' Department

H. P. BAUMANN, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

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

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART I

May 12, 1932, 1:30 P. M. to 6:30 P. M.

The candidate must answer the first three questions and any two of the remaining four questions.

Answer no more than five questions.

No. 1 (25 points):

From the following trial balance and accompanying data you are required to prepare a balance-sheet, as at December 31, 1930, and a profit-and-loss account for the year ended that date:

COMPANY A, INC.

Trial-balance—December 31, 1930

	DR.	CR.
Cash	$ 260,000	
Accounts receivable—customers	520,000	
Furniture and fixtures	20,000	
Depreciation reserve—furniture and fixtures		$ 2,000
Auto, trucks	60,000	
Depreciation reserve—auto, trucks		20,000
Accounts payable—trade		45,000
Accrued payroll and property taxes		10,000
Capital stock		777,000
(Authorized and issued, 55,000 shares)		
Sales		720,000
Purchases—lumber, steel, etc.	430,000	
Wages	225,000	
Depreciation—auto, trucks	20,000	
" —furniture and fixtures	2,000	
Lease rentals	25,000	
Selling and administrative expenses	12,000	
	$1,574,000	$1,574,000

Company A, Inc., rented display equipment on contract, and had obtained contracts for $720,000, covering a period of three years from January 1, 1930. The contracts provided that the company would bill for the earned portion of the contract price at the rate of $20,000 at the end of each month, beginning January 31, 1930.

The display equipment available for rental was constructed entirely by Company A, and during the month of January, 1930, such equipment was produced at a cost of $600,000, with an estimated average life of five years.

The locations on which the display equipment was erected had been leased to Company A for a period of five years from January 1, 1930, and the leases specified that rents for the full period were payable in advance on January 1, 1930.

All display equipment owned by Company A was in use under the contracts noted. Maintenance of this equipment in efficient operating condition cost the company $55,000 annually.

Solution:

This problem appears to be subject to at least two acceptable solutions either of which might be considered correct, depending upon the interpretation of the problem by the candidate.

If the display equipment was especially constructed and erected for the particular three year contracts, and, if such equipment, because of its special construction and location has no value beyond the life of the present three year contracts, the cost of this equipment should be spread over a three year period.

If, however, the display equipment is of such nature that the probability of its being leased for the fourth and fifth years of its life is a reasonable assumption, the cost of the equipment may be spread over the estimated average life of five years.

While either interpretation seems acceptable, the following solution is based upon the latter assumption.

Explanatory Adjusting Entries

(1)

Display equipment	$600,000	
Maintenance expense	55,000	
Purchases—lumber, steel, etc.		$430,000
Wages		225,000
To distribute the cost of purchases of lumber, steel, etc., and wages between the cost of display equipment and maintenance expense.		

(2)

Depreciation—display equipment	120,000	
Reserve for depreciation of display equipment		120,000
To write off depreciation on display equipment on the basis of a five year useful life (see comment).		

(3)

Prepaid lease rentals	20,000	
Lease rentals		20,000
To set up the prepaid portion of lease rentals.		

(4)

Contracts receivable	480,000	
Accounts receivable—customers		480,000
To set up the contracts receivable as a separate account.		

COMPANY A, INC.

Working papers—December 31, 1930

	Trial balance		Adjustments		Profit and loss		Balance-sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$ 260,000						$ 260,000	
Accounts receivable—customers	520,000			(4) $ 480,000			40,000	
Furniture and fixtures	20,000						20,000	
Depreciation reserve—furniture and fixtures		$ 2,000						$ 2,000
Auto trucks	60,000						60,000	
Depreciation reserve—auto trucks		20,000						20,000
Accounts payable—trade		45,000						45,000
Accrued payroll and property taxes		10,000						10,000
Capital stock (authorized and issued, 55,000 shares)		777,000						777,000
Sales		720,000	(5) $ 480,000					
			(6) 240,000					
Purchases—lumber, steel, etc.	430,000			(1) 430,000				
Wages	225,000			(1) 225,000				
Depreciation—auto, trucks	20,000				$ 20,000			
Depreciation—furniture and fixtures	2,000				2,000			
Lease rentals	25,000			(3) 20,000	5,000			
Selling and administrative expenses	12,000				12,000			
	$1,574,000	$1,574,000						
Display equipment			(1) 600,000				600,000	
Maintenance expense			(1) 55,000		55,000			
Depreciation—display equipment			(2) 120,000		120,000			
Reserve for depreciation—display equipment				(2) 120,000				120,000
Prepaid lease rentals			(3) 20,000				20,000	
Contracts receivable			(4) 480,000				480,000	
Deferred credit—reserve for contracts receivable and for deferred income thereon				(5) 480,000				480,000
Rental income				(6) 240,000		$240,000		
			$1,995,000	$1,995,000				
Net profit for the year					26,000			26,000
					$240,000	$240,000	$1,480,000	$1,480,000

(5)

Sales	$480,000	
Deferred credit—reserve for contracts receivable and deferred income thereon		$480,000

To relieve the sales account of the deferred credit on contracts—the earned portion to be billed monthly over the years 1931 and 1932.

(6)

Sales	240,000	
Rental income		240,000

To transfer rental income for the year 1930 from the sales account.

COMPANY A, INC.

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

Rental income			$ 240,000
Deduct:			
Depreciation:			
Display equipment	$120,000		
Auto trucks	20,000		
Furniture and fixtures	2,000	$142,000	
Rental		5,000	
Maintenance expense		55,000	
Selling and administrative expense		12,000	214,000
Net profit for the period			$ 26,000

Balance-sheet—December 31, 1930

Assets

Cash			$ 260,000
Accounts receivable—customers			40,000
Contracts receivable (see contra reserve)			480,000
Furniture and fixtures	$ 20,000		
Less reserve for depreciation	2,000	$ 18,000	
Auto trucks	$ 60,000		
Less reserve for depreciation	20,000	40,000	
Display equipment	$600,000		
Less reserve for depreciation	120,000	480,000	538,000
Prepaid lease rentals			20,000
			$1,338,000

Liabilities and net worth

Accounts payable—trade		$ 45,000
Accrued payroll and property taxes		10,000
Deferred credit—reserve for contracts receivable and deferred income thereon		480,000
Net worth:		
Capital stock—authorized and issued, 55,000 shares	$777,000	
Surplus	26,000	803,000
		$1,338,000

Another method showing the item of "accounts receivable—customers $520,000" appearing in the trial balance follows:

Accounts and contracts receivable	$520,000	
Less contracts not billed	480,000	
Accounts receivable		$40,000

If this method were followed, no reserve or deferred credit would be necessary.

Or, a footnote may be appended to the balance-sheet, stating that contracts receivable of $480,000, billable monthly at the rate of $20,000 a month, were held by the company.

No. 2 (22 points):

On July 15, 1930, a fire occurred at the plant of the X Corporation. Two-thirds of the inventory on hand at that date and one-half of the capital assets were destroyed.

The corporation had procured a one-year fire-insurance policy on January 1, 1930, with coverage of $40,000 on both inventory and capital assets, at a premium of $600. After the fire the insurance company allowed the corporation the full amount of its claim, based on book values.

There was no salvage value in the property destroyed.

You are requested to prepare a balance-sheet as at July 15, 1930, and a statement of surplus for the period from January 1 to July 15, 1930, taking up as an account receivable the amount due from the insurance company.

While engaged in this work, you ascertain the following particulars: the inventory at January 1, 1930, was valued at $32,000; purchases from January 1 to July 15, 1930, amounted to $36,000; and recorded sales, for the same period, to $57,000. You find, however, that a sale of merchandise, which was not recorded, was made just prior to the fire. This sale resulted in a gross profit of $1,500 and was made at an advance of three-eighths over cost.

A reconciliation with the bank statement, as of July 15, 1930, showed outstanding cheques, all dated July 10, 1930, as follows:

Payable to J. A. Jagger	$ 25.00
" " Marshall Company	62.50
" " United Savings and Loan Company—for deposit	50.00
" " Lampey & Co.	402.00
	$539.50

Other items under date of July 15, 1930, were: cashbook balance, $1,462; fixed assets and reserve for depreciation, $11,000 and $3,000 respectively; accounts receivable, $1,200; notes payable, $2,000; accounts payable, $2,600; and capital stock, $25,000.

A pass-book of the United Savings and Loan Company revealed a balance of $1,846 on July 1, 1930.

The surplus, January 1, 1930, was $13,000, and no entries had been made in the surplus account subsequent to that date.

From costing a representative number of recorded sales invoices, you determine that the gross profit amounted to forty-two and one-half per cent. (42½%) of cost.

Solution:

X CORPORATION

Balance-sheet—June 15, 1930

Assets

Current assets:			
Cash in banks:			
Subject to cheque	$1,462.00		
United Savings and Loan Company	1,896.00	$ 3,358.00	
Accounts receivable—customers'		6,700.00	
Due from insurance company		20,000.00	
Merchandise inventory		8,000.00	$38,058.00
Unexpired insurance			137.50
Fixed assets		$ 5,500.00	
Less reserve for depreciation		1,500.00	4,000.00
			$42,195.50

Liabilities and net worth

Current liabilities:		
Notes payable	$ 2,000.00	
Accounts payable	2,600.00	$ 4,600.00
Net worth:		
Capital stock	$25,000.00	
Surplus	12,595.50	37,595.50
		$42,195.50

Comments:

The outstanding cheque of $50 dated July 10, 1930, which was payable to the order of the United Savings and Loan Company, has been added to the balance in that account as on July 1, 1930, as shown by the passbook.

The accounts receivable have been increased by the amount of the unrecorded sale which resulted in a gross profit of $1,500. The details of this computation, and that determining the amount due from the insurance company, and the fixed assets, are as follows:

The unexpired insurance of $137.50 is based upon the following:

Premium paid, January 1, 1930, for insurance coverage for the entire year	$600.00
Monthly charge to operations—$^1/_{12}$ thereof	50.00
Chargeable for the period—January 1, 1930, to date of fire, July 15, 1930, is therefore, 6½ times $50 or	325.00
As shown below, the loss is exactly one-half of the original coverage, and therefore, the value of the unexpired insurance at July 15, 1930, is one-half of ($600–$325) $275 or	137.50

Computation of the Amount Due from Insurance Company

For merchandise:					
Inventory, January 1, 1930				$32,000.00	
Purchases—January 1, 1930 to July 15, 1930				36,000.00	
Total				$68,000.00	
Deduct cost of goods sold:					
Recorded sales at of cost	142½%		$57,000.00		
Less gross profit	42½		17,000.00		
Cost of goods sold	100%		$40,000.00		
Unrecorded sales of cost	137½%	$5,500.00			
Gross profit	37½	1,500.00			
Cost of goods sold	100%		4,000.00	44,000.00	
Estimated value of inventory at time of fire				$24,000.00	
Deduct portion not destroyed—⅓				8,000.00	
Portion of merchandise inventory destroyed by fire					$16,000.00
For fixed assets:					
Fixed assets per books				$11,000.00	
Less reserve for depreciation				3,000.00	
Book value				$ 8,000.00	
Deduct portion not destroyed—½				4,000.00	
Portion of fixed assets destroyed by fire					4,000.00
Amount due from insurance company					$20,000.00

The unrecorded sale of $5,500 was added to the accounts receivable as recorded on the books, which accounts for the balance of $6,700 appearing in the balance-sheet as the amount due from customers.

The portion of the inventory and the fixed assets not destroyed by the fire, $8,000 and $4,000, respectively, are taken up also into the balance-sheet.

While not required by the examiners, working papers accompany this solution for explanatory purposes, particularly to show the determination of the operating loss of $267 which appears in the statement of surplus on page 60.

X CORPORATION

Working papers—July 15, 1930

	Trial balance July 15, 1930 from data available		Adjustments		Profit and loss		Fire loss		Balance-sheet	
Cash—subject to cheque	$ 1,462.00								$ 1,462.00	
Fixed assets	11,000.00						$ 5,500.00		5,500.00	
Reserve for depreciation		$ 3,000.00						$1,500.00		$ 1,500.00
Accounts receivable—customers'	1,200.00		(1) $5,500.00						6,700.00	
Notes payable		2,000.00								2,000.00
Accounts payable		2,600.00								2,600.00
Capital stock		25,000.00								25,000.00
Surplus		13,000.00	(2) 137.50							12,862.50
United Savings and Loan Company	1,896.00								1,896.00	
Unexpired insurance	600.00			(2) $ 137.50	$ 325.00				137.50	
Inventory, January 1, 1930	32,000.00				32,000.00					
Purchases	36,000.00				36,000.00					
Sales		57,000.00		(1) 5,500.00		$62,500.00				
Expenses—to balance	18,442.00				18,442.00					
	$102,600.00	$102,600.00	$5,637.50	$5,637.50						
Estimated inventory at July 15, 1930						24,000.00	16,000.00		8,000.00	
Estimated operating loss						267.00			267.00	
Due from insurance company								20,000.00	20,000.00	
					$86,767.00	$86,767.00	$21,500.00	$21,500.00	$43,962.50	$43,962.50

(1) Unrecorded sale
(2) Portion of unexpired insurance premiums applicable to assets destroyed

X CORPORATION

Statement of surplus for the period January 1, 1930, to July 15, 1930

Balance, January 1, 1930			$13,000.00
Deduct:			
Loss for the period		$267.00	
Fire loss:			
Merchandise	$16,000.00		
Fixed assets	4,000.00		
Portion of unexpired insurance premiums	137.50		
Total	$ 20,137.50		
Less insurance claim	20,000.00	137.50	404.50
Balance, July 15, 1930			$12,595.50

ILLINOIS C. P. A. EXAMINATION

The following problem was set by the University of Illinois board of examiners in the November, 1931, examinations:

Problem:

Murray Rand, one of three trustees appointed under the will of the late Arthur Seller, asks you to prepare a consolidated balance-sheet of the various interests controlled by the trustees. These interests consist of undistributed income, and 90 per cent. of the stock of the Cortex Corporation. The Cortex Corporation owns 96 per cent. of the stock of Downey Investments, Ltd., an English corporation. These corporations were established by Mr. Seller for the purpose of holding investments made by him. Mr. Rand, his son-in-law, who has always managed these companies, owns the minority stock of both.

Under the terms of the will, the three trustees are to act as directors of the two corporations, pay the widow a minimum of $30,000 annually for her maintenance, and reinvest any surplus. They may also combine the two corporations or dissolve them at their pleasure. You are informed that the trustees are considering the desirability of an immediate consolidation of the various interests under one head.

You find that the three trustees account for their transactions as follows:

Particulars	Investments in bonds	Stock of Cortex Corporation	Cash in bank
On hand at date of death (April 10, 1925)		$1,315,155.73	
Dividends from Cortex Corporation			$297,000.00
Purchase of bonds	$186,870.83		*186,870.83*
Sale of bonds	*136,808.33*		137,647.45
Interest received			99,023.32
Distributions to Mrs. Seller			*336,966.19*
Taxes and expenses			*7,345.28*
Balance—September 30, 1931	$50,062.50	$1,315,155.73	$ 2,488.47

The last coupons clipped from the 6 per cent. bonds on hand on September 30, 1931, bore the date of September 15, 1931. The par value of the bonds is $50,000 and their cost and present market value $50,062.50. The investment in the Cortex Corporation is shown at the value reported for federal estate tax purposes which the trustees believe to be fair. This value represents the original cost of $900,000 plus appreciation of securities and the gain from conversion of the foreign holdings at the then current rate of exchange.

The Cortex Corporation was established on July 1, 1921. You find that its financial position on various dates has been as follows:

Assets

	July 1, 1921	April 10, 1925	Sept. 30, 1931
Cash in banks	$1,000,000.00	$ 124,528.20	$ 195,353.39
Investments, at cost		1,905,724.91	1,628,958.52
Accrued interest		15,733.60	37,692.08
Stock in Downey Investments, Ltd.		336,303.36	336,303.36
Total assets	$1,000,000.00	$2,382,290.07	$2,198,307.35

Liabilities and net worth

	July 1, 1921	April 10, 1925	Sept. 30, 1931
Notes payable		$1,036,000.00	$ 436,000.00
Capital stock	$1,000,000.00	1,000,000.00	1,000,000.00
Earned surplus		346,290.07	762,307.35
Total liabilities and net worth	$1,000,000.00	$2,382,290.07	$2,198,307.35

For federal estate tax purposes, the investments at April 10, 1925, were valued at $1,986,324.87, their market value at that date. Of this amount securities which cost $775,692 and had a market value of $789,620 at April 10, 1925, were on hand at September 30, 1931. The market value of all the securities at the latter date was $1,702,340.90.

Balance-sheets of Downey Investments, Ltd., which was incorporated at January 1, 1925, were:

Assets

	Jan. 1, 1925	April 10, 1925	Sept. 30, 1931
Cash in bank	£74,000	£ 25,000	£ 64,000
Investments, at cost		105,000	100,000
Total assets	£74,000	£130,000	£164,000

Liabilities and net worth

	Jan. 1, 1925	April 10, 1925	Sept. 30, 1931
Note payable		£ 50,000	
Capital stock	£74,000	74,000	£ 74,000
Earned surplus		6,000	90,000
Total liabilities and net worth	£74,000	£130,000	£164,000

The market value of the investments on April 10, 1925, as determined for federal estate tax purposes, was £105,800, or $505,618.20. Of this total, securities purchased on January 2, 1925, which had cost £25,000, and had a market value of £25,500 on April 10, 1925, were still on hand at September 30, 1931; the balance of £75,000 had been purchased on February 3, 1931.

On September 30, 1931, the market value of all the securities on hand was £130,000; there was no interest accrued on them. No dividends have ever been paid by Downey Investments, Ltd.

Rates of exchange on various dates were as follows:

January 1–2, 1925	4.734
April 10, 1925	4.779
February 3, 1931	4.75
September 30, 1931	3.915

Mr. Rand requests you to accept, in lieu of cost for balance-sheet valuation purposes, the market value of the securities at the date of death in order that the accountability of the trustees for subsequent events may be properly displayed. You may, of course, qualify your balance-sheet in any way. You are also requested to give such summary figures under the heading of net worth as will indicate the disposition, if any, of earnings. Mr. Rand's investment is to appear as a minority interest with such details thereof as you believe will be of interest to him.

Your solution is to consist of a consolidated work sheet suitable for presentation to the trustees, together with a balance-sheet prepared therefrom. No reserve (on account of the present depreciated pound) need be provided on the cost of the securities owned by Downey Investments, Ltd., owing to the offsetting increase in market values. Market prices of securities should be shown parenthetically only.

Solution:

Explanations of the adjustments and the eliminations shown in the consolidated working papers.

(1)

Accrued interest on investments	$ 125.00	
Earned surplus—Estate of Arthur Sellers		$ 125.00

To provide for interest at the rate of 6% per annum from September 15, 1931, to September 30, 1931, on the $50,000 par value of bonds held by the Estate of Arthur Sellers.

(2)

Investments on hand at date of death	17,442.50	
Unearned appreciation:		
Cortex Corporation		13,928.00
Downey Investments, Ltd.		3,514.50

To write up the value of the securities to the market value at the date of death of Arthur Sellers as follows:

	Cortex Corporation	Downey Investments Ltd.
Market value at date of death of securities on hand at September 30, 1931	$789,620.00	$121,864.50
Cost, per books	775,692.00	118,350.00
Unearned appreciation	$ 13,928.00	$ 3,514.50

NOTE.—The conversion of the security values from English pounds to dollars was made as follows:

	Value expressed in pounds	Rate of conversion	Value expressed in dollars
Market value at April 10, 1925	£25,500	4.779	$121,864.50
Cost at January 2, 1925.......	£25,000	4.734	118,350.00

(3)

Cortex Corporation:		
Capital stock..............................	$900,000.00	
Earned surplus.............................	384,201.03	
Downey Investments, Ltd.:		
Earned surplus.............................	30,954.70	
Investments in Cortex Corporation..........		$1,315,155.73

To eliminate the investment in the Cortex Corporation as follows:

The value of the stock of the Cortex Corporation of which 90 per cent. was held by Mr. Sellers at the date of his death, April 10, 1925, is given in the problem as $1,315,155.73. This amount gives effect to the adjustment in the market price of the investments held, including the 96 per cent. interest in the stock of Downey Investments, Ltd. The balance-sheet of Downey Investments, Ltd., at April 10, 1925 shows:

Capital stock..................................	£74,000
Surplus..	6,000
Total..	£80,000
to which should be added the increase in the value of investments held amounting to....................	800
making the adjusted net worth....................	£80,800

Converting this adjusted net worth into dollars at the rate of exchange prevailing at April 10, 1925, we find that the net worth expressed in dollars of Downey Investments, Ltd., was $386,143.20, and that the 96 per cent. interest therein held by the Cortex Corporation was 96 per cent. of $386,143.20, or $370,697.48.

The problem states that the investments held by the Cortex Corporation were valued for federal estate tax purposes at..	$1,986,324.87
and the balance-sheet shows that the cost of these investments was..	1,905,724.91
which makes the market value at the date of death...........	$ 80,599.96

in excess of cost.

THE ESTATE OF ARTHUR SELLERS

Consolidated working papers—September 30, 1931

Assets	Estate of Arthur Sellers	Cortex Corporation	Downey Investments, Ltd. Amount in pounds	Downey Investments, Ltd. Rate of exchange	Downey Investments, Ltd. Amount in dollars	Adjustments and eliminations Debit	Adjustments and eliminations Credit	Consolidated balance-sheet
Cash	$ 2,488.47	$ 195,353.39	£ 64,000	$ 3.915	$250,560.00			$ 448,401.86
Investment in Cortex Corporation	1,315,155.73						(3) $1,315,155.73	
Accrued interest on investments		37,692.08				(1) $ 125.00		37,817.08
Investments:								
On hand at date of death		775,692.00	25,000	4.734	118,350.00	(2) 17,442.50		911,484.50
Purchased since date of death	50,062.50	853,266.52	75,000	4.75	356,250.00			1,259,579.02
Stock of Downey Investments, Ltd.		336,303.36					(4) 336,303.36	
Total assets	$1,367,706.70	$2,198,307.35	£164,000		$725,160.00			$2,657,282.46
Liabilities and net worth								
Notes payable		$ 436,000.00						$436,000.00
Cortex Corporation:								
Capital stock		1,000,000.00				(3) 900,000.00		100,000.00 M
Earned surplus		762,307.35				(3) 384,201.03	(5) 12,535.20	76,230.73 M
Unearned appreciation								314,410.79 S
Downey Investments, Ltd.:						(5) 12,535.20	(2) 13,928.00	1,392.80 M
Capital stock			£ 74,000	4.734	$350,316.00	(4) 336,303.36		14,012.64 M
Earned surplus			90,000	Balance	374,844.00	(3) 30,954.70	(5) 3,036.53	50,978.78 M
								295,947.05 S
Unearned appreciation						(5) 3,036.53	(2) 3,514.50	477.97 M
Estate of Arthur Sellers:								
Estate corpus	$1,315,155.73							1,315,155.73
Earned surplus	52,550.97						(1) 125.00	52,675.97
Total liabilities and net worth	$1,367,706.70	$2,198,307.35	£164,000		$725,160.00	$1,684,598.32	$1,684,598.32	$2,657,282.46

The adjusted net worth of the Cortex Corporation and the proportionate interest therein (90%) held by Mr. Sellers is detailed below:

			Held by Mr. Sellers (90%)
Capital stock		$1,000,000.00	$ 900,000.00
Surplus	$346,290.07		
Increase in market value of investments	80,599.96	426,890.03	384,201.03
Increase in value of investment in Downey Investments, Ltd.:			
Market value	370,697.48		
Cost	336,303.36		
Increase		34,394.12	30,954.70
Totals		$1,461,284.15	$1,315,155.73

(4)

Downey Investments, Ltd.—capital stock	336,303.36	
Stock of Downey Investments, Ltd.		336,303.36

To eliminate the investment in stock of Downey Investments, Ltd.

(5)

Unearned appreciation:		
Cortex Corporation	12,535.20	
Downey Investments, Ltd.	3,036.53	
Earned surplus:		
Cortex Corporation		12,535.20
Downey Investments, Ltd.		3,036.53

To transfer the unearned appreciation applicable to the estate as follows:

		Estate's portion	
	Amount	Percentage	Amount
Cortex Corporation	$13,928.00	90%	$12,535.20
Downey Investments, Ltd.	3,514.50	90% of 96%	3,036.53

A recapitulation of the consolidated surplus items in the working papers shows:

Earned surplus:	
Cortex Corporation	$314,410.79
Downey Investments, Ltd.	295,947.05
Estate of Arthur Sellers	52,675.97
Total	$663,033.81
If to this amount is added the distributions to Mrs. Sellers of	336,966.19
we find that the profit for the period from April 10, 1925, to September 30, 1931, was	$1,000,000.00

ESTATE OF ARTHUR SELLERS

Consolidated balance-sheet—September 30, 1931

Assets

Cash			$ 448,401.86
Investments (market value, $2,261,353.40):			
Acquired prior to date of death, at market value on April 10, 1925		$ 911,484.50	
Acquired since date of death, at cost		1,259,579.02	2,171,063.52
Interest accrued on investments			37,817.08
Total assets			$2,657,282.46

Liabilities and net worth

Notes payable			$ 436,000.00
Minority interests of Murray Rand in Cortex Corporation and Downey Investments, Ltd.:			
Investments		$ 114,012.64	
Earned surplus		127,209.51	
Unearned appreciation on investments		1,870.77	243,092.92
Net worth:			
Estate Corpus		$1,315,155.73	
Earned surplus:			
Net profit for period from April 10, 1925, to September 30, 1931	$1,000,000.00		
Less—cash paid to Mrs. Sellers	336,966.19	663,033.81	1,978,189.54
Total liabilities and net worth			$2,657,282.46

Book Reviews

PREFERRED STOCKS AS LONG TERM INVESTMENTS, by R. G. RODKEY. *University of Michigan, Ann Arbor. 304 pages.*

Here is a pamphlet which undertakes to prove that while there is apparently a good deal of truth in the statements that have been made from time to time by various authorities on investments that preferred stocks, and particularly industrial preferred stocks, are the least desirable type of securities to hold, this is not true of industrial preferred stocks which are not junior to bond issues.

To prove his point the author has accumulated data showing the results over a 24-year period of an investment of $10,000 made on January 2, 1908, in various groups of 10 preferred stocks listed on the New York stock exchange ($1,000 per company). The various preferred stock issues are grouped as follows:

1. Industrial preferred stocks preceded by bonds throughout the period.
2. Railroad preferred stocks preceded by bonds throughout the period.
3. Industrial preferred stocks preceded by bonds at the beginning of the period, but not sold and the money re-invested when the bonds subsequently were paid off.
4. Industrial preferred stocks not preceded by bonds at the beginning of the period but not sold and the money re-invested when the companies subsequently issued securities senior to the original investment.
5. Industrial preferred stocks not preceded by bonds at any time throughout the period.

The results of the tests are summarized on page 26 of the pamphlet and in the main justify the worst that has been said about preferred stocks by the investment authorities. The stocks selected for the tests were the preferred stocks of companies whose common stock sales were the largest on the New York stock exchange in the year preceding purchase. Comparisons are given of the results of similar investments of $10,000 in the common stocks and bonds of the same companies. The increase or decrease by January 2, 1932, in the value of the $10,000 invested on January 2, 1928, in the various classes of securities described above is as follows:

Type of company	Common stock	Preferred stock	Bonds
1	+ 629	—5404	—1999
2	— 4935	—5124	—1537
3	— 2443	—5086	....
4	+ 9809	—3006	....
5	+26.279	+1035	....

The tables appended to the pamphlet show that preferred stocks of type 5 have been fairly steady throughout the period. However, the fact that the common stocks of the same companies appreciated in value by over 260% during the period raises the question as to whether this steadiness was not more due to the fact that the companies selected turned out to be extremely successful ones than to the fact that they never had bonds outstanding.

The statistics accompanying the pamphlet may be of interest to insurance companies or other concerns having to do with the investment of money but to the layman this type of article appears to be more apt to be misleading than otherwise.

George M. Barr.

SYSTEMS INSTALLATION IN ACCOUNTING, by George J. Geier and Oscar Mautner. *Burrell-Snow, Inc.*, New York. 500 pages.

Most books on system work deal with the requirements of particular enterprises. One that promises a more general treatment always awakens the interest of student and practitioner, and after reading the commendatory send-off and the narration of purpose in the introduction and the preface of the book now before me I expected to review a noteworthy contribution to the literature on the subject. I looked for a description and illustration of up-to-date general accounting methods and also hoped for a presentation in good form such as reader and student may rightfully expect. Alas, I am sadly disappointed.

As to substance, there is very little in the book that is new and much that was antiquated practice long ago. The chapters on mechanical accounting may be classed as dealing with what is new. They show very good pictures of the many types of modern accounting equipment, give descriptions of certain general and specific advantages and of particular use and method of operation. These descriptions are too voluminous for the general mention of principal features and characteristics such as a book of this kind should offer. On the other hand, they are entirely inadequate for a full understanding of detailed workings and applications.

Among the antiquated practices may be mentioned the use of the purchase order-, invoice- and sales-order registers. Records of this sort are not generally kept any more and are among the first that would be eliminated in the revision of a system. I failed to see a voucher-payable form either illustrated or described. The voucher record, while serviceable in most instances, does not show any device for the control of inward freight and delivery charges or for a more flexible treatment of the creditors' accounts, and no mention is made in the text of either. Nor do the sales records or their description give evidence of any provision for the control of outward delivery charges. All this, and much more, may yet be forthcoming in the supplement to the present volume announced in the preface. There is, of course, a good deal of material that is of some use to the beginner, but most of it is trite and repetitious and obvious to anyone who has advanced far enough in the study or practice of accountancy to take up system work.

The book is equally unsatisfactory as to form and style. There is an overabundance of needless charts and diagrams. Fig. 1 illustrates the point. It shows the "objective of constructive accounting" in one sentence that would have been innocent enough in the text. For the purposes of the chart it is chopped up into words, single or in groups. Words and groups are put into triangles, squares and quadrangles, together making a more or less symmetrical picture. The arrangement adds nothing to the significance of the words or the thought behind them; it even detracts from both. There are many charts of this type that would have been much better left out.

Without expecting literary excellence it seems only fair that the book should come up to ordinary standards in professional writing. However, its pages abound with terms that have become the jargon of the illiterates in the trade. An accounting system "embraces" certain books; transactions are "embraced" by activities; a view "embraces" accounting activities—all this on one single page. Books, accounts, statements, columns, etc. "reflect" amounts, numbers, answers. Occasionally I encounter gems like "bisection of operation"; "fool-proof against fraud"; "multiple" (meaning "many") purchases; "data" used as a singular; and many other faults of speech and style—in fact too many to waste time in denouncing them. Quite ordinary expedients are presented as "fundamental principles" and I also note the use of the term "system builder" —a rhetorical overstatement of the same charm and merit as "shirt builder," "beautician," "mortician," "realtor" and others that now enjoy popularity.

The book could have been dismissed with fewer words. I thought it better, however, to show some of the specific reasons why it should be classed among the inadequate treatments of a subject whereon thus far only too few competent works have been written.

A. van Oss.

BANKING, by Prof. Frederick A. Bradford, *Longmans, Green & Co.* 500 pages.

Banking, by Professor Bradford, is a book calling for review by a banker rather than by an accountant. It is devoted partly to a history of the development of American banking from its beginning to 1932. This is followed by an elaborate exposition of banking mechanics as now practised. So far as it deals with accounting matters it is not open to fault finding.

Assuming that all the matter contained in this work be correct—and I do not question the correctness of any of it—it does give a picture of the development of American banking that might almost be considered, even by a layman, as interesting reading. However, the bibliographical notes indicate that its study should be supplemented by the study of a quantity of other banking literature so vast that much courage would be needed to undertake its reading. There are 14½ solid pages of these bibliographical notes; I decided not to read all those books. *Banking* is probably a very excellent text book. Certainly it is well written; but let a banker pass judgment on the banking matters, especially on the discussion of the federal reserve system, which is now under fire.

F. W. Thornton.

ECONOMICS OF PUBLIC UTILITIES, Second Edition, by L. R. Nash. *McGraw-Hill Book Co., Inc.*, New York. 508 pages.

In 1925 Mr. Nash took the courageous and ambitious step of publishing the first comprehensive text in the field of public utility economics. In the last two decades prior to that year, public utilities had taken enormous forward strides in every direction. Much had been written, piecemeal, about the various problems of the industry. Specific questions had been dealt with at length in the decisions of regulatory commissions and courts. Books and monographs had likewise been published on different phases of the problem. None, however, had undertaken the task of consolidating this knowledge and opinion into a unified text covering the entire field. In devoting himself to this enormous task, Mr. Nash wisely limited his survey to electric light and power, electric railway and gas utilities.

He brought to his task many years of practical operating knowledge of such utilities, combined with thorough study and research, and produced a valuable and interesting survey of the problems of the industry and their possible solutions. The book had the natural faults of a first achievement, and much has been written on the subject since. The industries involved have likewise developed phenomenally in the past six years and the second edition of the book is a very thorough revision in the light of these developments.

This book has the natural advantages and disadvantages which come from the closeness with which its author has been identified with the field of endeavor which he discusses. For the practical man, the investor, the accountant, the lawyer, the banker who wishes to obtain without too much study a useful working understanding of the field, it is invaluable. The chapters on capitalization, accounting, rate of return to investors, tests of utility securities as investments are outstandingly valuable from this point of view. For those who want a more complete understanding of the problems involved, the chapters on regulation, valuation, rate structures and taxation are excellent. From lack of space they are necessarily sketchy but contain as much meat as the busy man not primarily engaged in the field can digest. The chapter on depreciation is probably the most thorough in the entire book and a most valuable contribution to the literature of the subject.

For the specialist, the student or the expert, the book has the disadvantages which, like its advantages, arise from the author's close practical relation to the work. He is too near to his subject to obtain an entirely balanced view of it, and predilection and prejudice necessarily affect some of his conclusions. The breadth and scope of the subject also limit the author to a rather elementary treatment of a number of important subjects. It is, all in all, an excellent book which will bring the theorist into contact with realities, stimulate the expert to careful, critical thought and adequately inform the practically interested amateur in the subject.

Alexander Grant.

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.]

ACCOUNTING FOR DIVIDENDS

Question: I would be obliged if you would obtain for me the proper accounting for dividends received which had been declared prior to the time the stock on which they were declared was purchased.

In other words, if a corporation buys the stock of another corporation or a part of it after a quarterly dividend has been declared, and as a result of the declaration pays a higher price for the stock than it would have paid had the dividend not been declared, should the dividend when received be credited to the cost of the stock or treated as current income from dividends?

Answer No. 1: We understand that the particular case involved is one in which the purchase of stock occurs before the stock sells "ex-dividend" or, if the purchase is made outside an exchange, no suggestion is made that the dividend is being purchased separately.

It is a general practice to consider the entire cost of the stock as an investment and to take up the dividend as income when received, even though the dividend may be paid for as part of the purchase price of the stock. This view is taken by the United States treasury for income-tax purposes, although there is some indication that in a case directly in point the board of tax appeals might adopt the opinion that the dividend in question is a return of capital.

However, the proper accounting practice is to treat any dividend which was declared prior to the purchase of the stock and is payable shortly thereafter as a return of principal rather than income. This practice is in accord with logic as a dividend received would not be an actual "earning" or "income" to the investor when, as a matter of fact, there had been no investment during any substantial period of time antedating the dividend payment.

If the stock is purchased for a stated price and a separate amount is shown as the purchase price of the dividend, then clearly the purchase price of the stock should appear separately in the accounts, and the dividend when received should be credited to the cost of the dividend, with nothing taken up for it in income.

Answer No. 2: It is common practice among stock-exchange houses to credit income account with dividends received on stocks purchased between the date of the dividend declaration and the record or ex-dividend date; dividends on stocks purchased between the ex-dividend date and the date of payment are, of course, received by the seller. In the ordinary case, therefore, the receipt of a quarterly dividend, in circumstances such as these, may be credited to income.

There are many cases, however, when the receipt of a dividend (not necessarily of a liquidating nature) may represent a return of capital to a recent purchaser. Such cases are frequent when control of one company is acquired by another, and the dividend is, in effect, paid out of surplus at acquisition. The circumstances surrounding the acquisition of a substantial block of stock in a company will usually indicate readily whether or not the dividend payment comes within this category, but in cases of this nature the accountant must study the facts carefully before reaching his conclusion.

Answer No. 3: The dividend in question is not income. The amount of it should be credited to the investment if that account has been charged with the full cost of the stock, although a better treatment of the transaction in journal form follows:

On acquisition of stock:		
Dividend receivable......................	$........	
Investment in stock of *Y* Co...............	....	
To cash...............................		$........
On receipt of dividend:		
Cash...................................	$........	
To dividends receivable.................		$........

CLAIM FOR FIRE LOSS

Question: I have been consulted as to whether or not a claim against an insurance company for fire loss can be entered into an account entitled "insurance receivable" or "insurance claims receivable." Are these terms, in your opinion, theoretically correct?

Answer: In our opinion it would be proper to enter such a claim for fire loss in an account entitled either "insurance receivable" or "insurance claims receivable," preferably the latter since the caption is more descriptive.

The status of the claim, however, would have a considerable bearing on the propriety of entering it on the books. If the fire had just occurred and the claim had not been approved by the insurance company the receivable should not be carried on the books. On the other hand, if the claim had been admitted by the insurance company and was merely awaiting the formality of payment, it would be proper to take it up as a receivable and as a current asset. The description of the account is important in clearly disclosing the status of the claim. Until a claim has been recognized, the book loss sustained through fire should be carried in a suspense account, usually entitled "fire-loss account," which would appear in the balance-sheet, among the miscellaneous assets or deferred charges.

COST OF CAPITAL SUPPLIED TO SUBSIDIARIES

Question: A holding company which owns the majority of stock or the controlling interest in several companies operating public utilities provides its constituents with financial, legal, engineering and management services, in return for which its receives a definite percentage of the gross revenue of its operating companies. The magnitude of the operations and the service required by each of the operating companies vary according to the communities served and the services rendered by the holding company. All the operating companies share the management services in a greater or less degree.

The holding company provides the cash funds required annually by each of the operating companies. It finances its own operations through sale of bonds to the public, by loans from bankers and other fiscal sources and by the sale of common stock, the latter frequently at a premium. Bonds have been sold bearing interest at varying rates, not exceeding 5½ per cent. on the nominal value; temporary loans have been raised at generally lower rates and annual dividends of 12 per cent. have been paid on the par value of the common stock.

What should be considered "the cost of capital" supplied to the operating companies in any one year?

Answer No. 1: Assuming that the phrase "cost of capital" is intended to refer to the rate of interest at which subsidiaries should be charged for advances made to them by the holding company throughout a given year, we may say that, in our opinion, where advances made to subsidiaries may be earmarked as representing the proceeds of specific loans, the effective rate of interest payable by the holding company on such loans indicates the cost of the capital and should be charged to the subsidiary. On the other hand, it would seem to us that a reasonable rate of interest, not in excess of the effective rate at which funds might be obtained by the respective subsidiaries in the open market, should be charged in the case of advances made to subsidiaries from the proceeds of sales of common stock or from undistributed profits.

While directly applicable to the capitalizing of interest during construction, the following quotation from the interstate commerce commission's regulations for steam roads, is, we think, pertinent to the present discussion:

> When any bonds, notes, or other evidence of indebtedness are sold, or any interest-bearing debt is incurred . . . the interest accruing on the part of the debt representing the cost of property chargeable to road and equipment accounts (less interest, if any, allowed by depositaries on unexpended balances) . . . and such proportion of the discount and expense on funded debt issued . . . as is equitably assignable . . . may be capitalized. Interest during construction shall include reasonable charges for interest, during the construction period . . . on the carrier's own funds expended for construction purposes.

As to "what should be considered 'the cost' to the holding company of capital supplied to the operating companies in any one year," we do not see that it is possible accurately to determine this in cases wherein such capital represents proceeds from sale of the holding company's common stock and undistributed profits. Any attempt at finding such a cost would necessarily be arbitrary.

Answer No. 2: According to the question the holding company, which provides the cash funds required annually by each of the operating companies, finances its own operations through various sources, namely:

(1) by the sales to the public of bonds bearing interest at varying rates not exceeding 5½ per cent. on the nominal value;
(2) by loans from bankers and other fiscal sources at interest rates generally lower than in (1);
(3) by the sale of common stock, frequently at a premium, annual dividends of 12 per cent. having been paid on the common stock.

The several companies, though separate legal units, comprise, for operating and financial purposes, a composite entity, and the financial requirements of the group are provided out of a common fund. It, therefore, follows that the total cost of capital, the interest, assumed in the first place by the holding company, should be pro-rated to the constituent companies in proportion to the funds used by each of the companies in any year.

In other words, the average rate of interest should be determined on both funded debt and current borrowings and such rate charged on the average balances due from the operating companies, the balance of interest paid being chargeable to the holding company. It does not seem to us that the interest charged by the holding company should be loaded, inasmuch as, apart from other considerations, it undertakes, among other things, to provide financial services for the agreed compensation—though no great objection could be urged against a small increase to the average interest rate mentioned.

Further, the rate of dividends that have been paid on the holding company's common stock is not a factor in the cost of capital. The funds derived from capital stock may be transferred in part to the operating companies but the rate of interest is that at which experience shows the holding company is able to raise funds by the issue of bonds and from current borrowings, as distinct from the rate of income distributed from earnings on proprietors' capital.

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.]

ACCOUNTANCY

Germany

Rumsey, F. *Compulsory Audits and the Certification of Accountants and Auditors in Germany.* ACCOUNTANT, May 28, 1932, p. 733–5.

ACCOUNTANTS' OFFICE

Gates, Harold T. *Don't Drop the Pilot to Lighten the Load.* MANAGEMENT METHODS, May 1932, p. 282–3, 317–9.

ACCOUNTING

Adamson, R. *Accounting as a Service to Management.* COMMONWEALTH JOURNAL OF ACCOUNTANCY, March 1932, p. 205–13.

Lukens, William Penn. *Partnership Between Accounting and Management.* New York, National Association of Cost Accountants, May 15, 1932. (N. A. C. A. BULLETIN, vol. 13, no. 18, section 1, p. 1227–38.)

Problems

Williams, Glynne. *Practical Accounts for Examinees.* ACCOUNTANTS' JOURNAL (Eng.), May 1932, p. 15–24.

AIRPORTS

Accounting

Ellenberger, I. W. *Airport Accounting.* AVIATION ENGINEERING, May 1932, p. 51, 53.

ARCHITECTS

Accounting

Brown, Oswald M. *Architects' Accounts.* London, Gee and Company, Limited, 1932. 117 p.

BANKRUPTCY

England

Allcorn, James. *Criminal Offences in Bankruptcy.* ACCOUNTANTS' JOURNAL (Eng.), May 1932, p. 25–31.

BANKS AND BANKING

Bradford, Frederick A. *Banking.* New York, Longmans, Green and Company, 1932. 499 p.

Failures and Defalcations

Spahr, Walter E. *Bank Failures in the United States.* AMERICAN ECONOMIC REVIEW, March 1932, p. 208–38.

Law

Massachusetts

Hughes, Elliot B. *Statutory Requirements for Examinations of Banking Enterprises in Massachusetts subject to State Control and Supervision.* L. R. B. & M. JOURNAL, May 1932, p. 8–13, 17.

BIBLIOGRAPHIES, INDEXES, CATALOGUES, ETC.

Accountants' Index, Third Supplement; a Bibliography of Accounting Literature, January, 1928–December, 1931 (Inclusive). New York, American Institute Publishing Company, Incorporated, c 1932. 635 p.

BOOKKEEPING

Sprott, A. F. and Short, Frank G. *Canadian Modern Accounting—Elementary Theory of Bookkeeping; an Introduction to Canadian Modern Accounting, Part 1.* Toronto, Canada, Commercial Text Book Company, c 1927. 375 p.

BUDGETS, BUSINESS

Metropolitan Life Insurance Company. Policyholders Service Bureau. *Manufacturing Expense Budget.* New York, Metropolitan Life Insurance Company (1932). 23 p.

BUDGETS, NATIONAL

Klein, Joseph J. *Can the National Budget be Balanced?* AMERICAN ACCOUNTANT, April 1932, p. 113–4.

BUILDING AND LOAN ASSOCIATIONS

Auditing

Sternrich, L. M. *Audit Procedure in the Examination of New Jersey Building and Loan Associations.* CERTIFIED PUBLIC ACCOUNTANT, May 1932, p. 270–5.

CERTIFICATES

Himmelblau, David. *Current Thoughts on Auditors' Certificates.* CERTIFIED PUBLIC ACCOUNTANT, May 1932, p. 263–9, 280.

CHAIN STORES

Accounting

Schuster, George A. R. *Chain-Store Accounting.* JOURNAL OF ACCOUNTANCY, June 1932, p. 433–41.

CHARITIES

Accounting

Kassander, A. R. *Organization and Operation of the Accounting Division of the Emergency Unemployment Relief Committee in New York City.* L. R. B. & M. JOURNAL, May 1932, p. 1–7.

CLOTHING

Cost Accounting

Rositzke, R. H. *Standard Costs as Applied to Dress Manufacture.* New York, National Association of Cost Accountants, May 15, 1932. (N. A. C. A. BULLETIN, vol. 13, no. 18, section 1, p. 1239–58.) Printed with: Lukens, William Penn. *Partnership Between Accounting and Management.*

COMMERCE

Stephenson, James. *International Trade.* ACCOUNTANTS' JOURNAL (Eng.), May 1932, p. 42–60.

DEBT, INTERNATIONAL

Sadd, C. T. A. *Debts and Disarmament.* ACCOUNTANT, April 30, 1930, p. 585–9.

DEPARTMENT STORES

Statistics

Gault, Edgar H. *Performance of Department Stores: 1931.* Ann Arbor, Michigan, University of Michigan, School of Business Administration, Bureau of Business Research, 1932. 452 p. (Michigan Business Studies, vol. 4, no. 4.)

DEPRECIATION, DEPLETION AND OBSOLESCENCE

Buildings

"*Obsolescence Insurance.*" BUILDING AND BUILDING MANAGEMENT, May 2, 1932, p. 34.

Public Utilities

Riggs, Henry Earle. *Two Radically Different Concepts of Utility "Depreciation."* PUBLIC UTILITIES FORTNIGHTLY, May 12, 1932, p. 559–68.

ERRORS

Seely, F. Howard. *Transposition of Figures.* JOURNAL OF ACCOUNTANCY, June 1932, p. 446–51.

EXAMINATIONS

American Institute of Accountants

American Institute of Accountants. *Examinations, May 1932.* JOURNAL OF ACCOUNTANCY, June 1932, p. 413–32.

C. P. A. Ohio

Dickerson, William E. and Jones, J. Weldon. *Ohio C. P. A. Problems; an Analytical Study of and Solution to the Problems Given by the Ohio State Board of Accountancy 1928–1931.* Columbus, Ohio, Ohio State University Book Store, 1932. Not paged.

Institute of Chartered Accountants in England and Wales

Westby-Nunn, Edward. *Last Minute Hints on the Legal Subjects of the May Examinations of the Institute.* ACCOUNTANTS' JOURNAL (Eng.), May 1932, p. 11–4.

EXECUTORS AND TRUSTEES

Auditing

Leo, R. J. *Audit and Examination of the Accounts of the Trust Estate; Functions and Duties of the Professional Accountant.* TRUST COMPANIES, May 1932, p. 631–4.

FOREIGN EXCHANGE

Heiser, H. C. *Foreign Exchange Problems.* L. R. B. & M. JOURNAL, May 1932, p. 14–7.

Hogg, S. R. *International Trade and the Exchange.* ACCOUNTANT, May 14, 1932, p. 657–62.

FOUNDRIES, IRON AND STEEL

Kellam, L. J. *Costing in Small Steel Rolling Mills.* COST ACCOUNTANT, May 1932, p. 350–4.

HOLDING COMPANIES

Carman, Lewis A. *Intercorporate Relationships.* AMERICAN ACCOUNTANT, April 1932, p. 103–8; May 1932, p. 140–1.

INSURANCE POLICIES

Accounting

Enloe, B. L. *Records for Insurance Policies.* JOURNAL OF ACCOUNTANCY, June 1932, p. 442–5.

LIQUIDATIONS AND RECEIVERSHIPS

Birch, T. Fleming. *Practical Points in "A Creditors' Winding-Up" Under Voluntary Liquidation.* ACCOUNTANTS' JOURNAL (Eng.), February 1932, p. 734–9.

LUMBER

Accounting

Ewing, J. Marshall. *Audits of Lumber Companies.* INTERNAL REVENUE NEWS, May 1932, p. 12–3.

MECHANICAL DEVICES

Clement, E. *Campos Machine.* ACCOUNTANT, April 23, 1932, p. 553–6.

MOTOR TRUCKS

Cost of Operation

Kuhner, T. H. *Truck Costs in Telephone Work; Analysis of Costs of Regular Truck Operators Engaged in Maintenance of Telephone Lines.* RAILROAD AND PUBLIC UTILITY ACCOUNTANT, June 1932, p. 20.

PAYROLL

Whye, Howe N. *How a Large Railroad Pays Its Employes.* RAILROAD AND PUBLIC UTILITY ACCOUNTANT, June 1932, p. 13–6.

PROPERTY

Accounting

Coes, Harold Vinton. *Appraisals and Property Accounting.* New York, National Association of Cost Accountants, May 1, 1932. (N. A. C. A. BULLETIN, vol. 13, no. 17, section 1, p. 1168–75.) Printed with: Olson, L. H. *Reappraisals and Major Readjustments in Property Values.*

PUBLIC UTILITIES

Accounting

Oliver, F. M. Milward. *Machinized Accounting System for Public Utilities.* RAILROAD AND PUBLIC UTILITY ACCOUNTANT, May, June 1932, p. 5–10; 5–11.

Seidman, M. L. *Depreciation and Retirement Problems of Utilities.* JOURNAL OF ACCOUNTANCY, June 1932, p. 452–60.

RAILROADS

Accounting

Barthe, J. Wilfrid. *Proposed Plan of Accounting for per Diem Based on Use of Machines at Centralized per Diem Accounting Bureaus.* RAILROAD AND PUBLIC UTILITY ACCOUNTANT, May 1932, p. 15–6.
Whye, Howe N. *Work of a Railroad Car Accountant.* RAILROAD AND PUBLIC UTILITY ACCOUNTANT, May 1932, p. 11–4.

REAL ESTATE

Valuation

Olson, L. H. *Reappraisals and Major Readjustments in Property Values.* New York, National Association of Cost Accountants, May 1, 1932. (N. A. C. A. BULLETIN, vol. 13, no. 17, section 1, p. 1155–64.)
Stempf, Victor H. *Should Major Readjustments of Property Values Be Made Through Capital Surplus or Earned Surplus?* New York, National Association of Cost Accountants, May 1, 1932. (N. A. C. A. BULLETIN, vol. 13, no. 17, Section 1, p. 1164–8.) Printed with: Olson, L. H. *Reappraisals and Major Readjustments in Property Values.*

REPORTS

Macphee, E. D. *Statistical Data and Reports for Management Control.* COST AND MANAGEMENT, May 1932, p. 135–9.
Sweeney, Henry W. *Making Reports to Stockholders Tell the Truth.* FORBES, April 1, 1932, p. 18–20, 26.

ROYAL MAIL STEAM PACKET COMPANY

Dixon, Stanley. *Some Reflections on the Royal Mail Steam Packet Case.* ACCOUNTANTS' JOURNAL (Eng.), February 1932, p. 716–33.

STATIONERS

Costs

Murchie, A. M. *Manufacturing Stationers' Costs.* COST ACCOUNTANT, May 1932, p. 335–40.

STORES SYSTEMS AND STOCK RECORDS

Holdsworth, A. *Stores Distribution.* COST ACCOUNTANT, May 1932, p. 347–9.

TAXATION

Sales

Buehler, Alfred D. *General Sales Taxation: Its History and Development.* New York, Business Bourse, 1932. 378 p.

TAXICABS

Accounting

Uniform Classification

Taxicab Accounting System Adopted by Connecticut; Uniform Classification of Accounts Required as an Aid to Operators and to Permit Closer Regulation. Companies Must Submit an Annual Report to the Commission. TRANSIT JOURNAL, April 1932, p. 173–5.

VALUATION

Lemley, B. W. *Value of Appraisals to the Cost Accountant.* New York, National Association of Cost Accountants, May 1, 1932. (N. A. C. A. BULLETIN, vol. 13, no. 17, section 1, p. 1175–80.) Printed with: Olson, L. H. *Reappraisals and Major Readjustments in Property Values.*

WAGES, FEES, ETC.

Incentives

Rice, G. W. *Wage Incentives.* COST AND MANAGEMENT, May 1932, p. 139–44.

WATERWORKS

Accounting

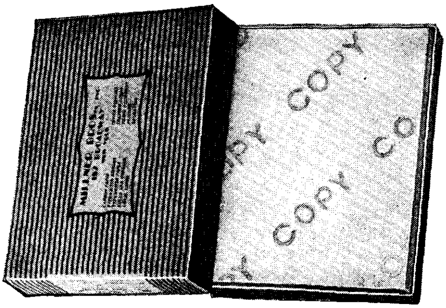
Hoffman, M. F. *Stub Plan of Customers' Accounting.* JOURNAL OF THE AMERICAN WATERWORKS ASSOCIATION, May 1932, p. 692–9, Discussion, p. 699–704.

WORKING PAPERS

Grahame, J. W. F. and Myers, Preston E. "*Unaform*" *Accounting Schedules.* Belleville, New Jersey, Yerg, Incorporated, c 1932. Forms.

Addresses of Periodicals:

Accountant, 8 Kirby Street, London, E. C. 1, England.
Accountants' Journal (Eng.), 8 Kirby Street, London, E. C. 1, England.
American Accountant, 225 Broadway, New York City.
American Economic Review, Association, Northwestern University, Evanston, Illinois.
Aviation Engineering, 22 East 40th Street, New York City.
Buildings and Building Management, 139 N. Clark Street, Chicago, Illinois.
Certified Public Accountant, National Press Building, Washington, D. C.
Commonwealth Journal of Accountancy, 59 William Street, Melbourne, Australia.
Cost Accountant, 6 Duke Street, St. James's, S. W. 1, London, England.
Cost and Management, 81 Victoria Street, Toronto, Canada.
Forbes, 120 Fifth Avenue, New York City.
Internal Revenue News, Treasury Department, Washington, D. C.
Journal of Accountancy, 135 Cedar Street, New York City.
Journal of the American Waterworks Association, 2411 North Charles Street, Baltimore, Maryland.
L. R. B. & M. Journal, 90 Broad Street, New York City.
Management Methods, 330 West 42nd Street, New York City.
N. A. C. A. Bulletin, 1790 Broadway, New York City.
Public Utilities Fortnightly, Munsey Building, Washington, D. C.
Railroad and Public Utility Accountant, 18 Huron Street, Chicago, Illinois.
Transit Journal, 330 West 42nd Street, New York City.
Trust Companies, 2 Rector Street, New York City.



THIS strong, attractive box contains 1000 sheets of Onionskin "Copy" paper, size 8½ x 11, with the word "COPY" *watermarked* — not printed — into each sheet as shown.

With a good lightweight Carbon Paper (which we sell) as many as 10 clear, lasting carbon copies are produced. Thin, non-curling, top side GLAZED to lend greater clarity to carbon copies, the use of this paper will save at least half of your filing cabinet space. Easy to handle, distinctive to look at, economical to use.

In White, Green or Goldenrod, $2.50 per box, prepaid

For complete catalogue, address

MILLNER BROS., INC.

187 Broadway New York, N. Y.

Classified Advertisements

Copy for classified advertising must be in hand at the office of The Journal of Accountancy previous to the twentieth day of the month preceding month of publication. Rates for "Help Wanted" and "Miscellaneous" are $9 per inch or fraction for one insertion; $7 per inch or fraction each additional insertion. "Situations Wanted," $5 up to 65 words each insertion.

HELP WANTED

If you are open to overtures for new connection and qualified for a salary between $2500 and $25,000, your response to this announcement is invited. The undersigned provides a thoroughly organized service of recognized standing and reputation, through which preliminaries are negotiated confidentially for positions of the calibre indicated. The procedure is individualized to each client's personal requirements, your identity covered and present position protected. Established twenty-two years. Send only name and address for details. R. W. Bixby, Inc., 125 Downtown Building, Buffalo, N. Y.

SITUATION WANTED

Certified Public Accountant

American Institute examination, desires connection as comptroller, auditor, accountant or similar position. Now employed in like capacity by nationally known manufacturing corporation. Thoroughly experienced in manufacturing and financial control, budgets, standard costs, taxes, etc. Age 38, Protestant. Highest recommendations as to character and ability. Moderate salary. Box No. 172, care of The Journal of Accountancy.

MISCELLANEOUS

Well established public accounting firm desires to represent certified firm in St. Louis. References exchanged. Box No. 173, care of The Journal of Accountancy.

Binding THE JOURNAL OF ACCOUNTANCY

In tan buckram with title, dates and volume number stamped in gold on red leather.

When the magazines constituting the volume are supplied by the subscriber the binding charge is $2. Each bound volume includes six issues.

Missing numbers, with the exception of a few rare issues, will be supplied, if obtainable, at 50 cents each.

Binding orders and the magazines to be bound should be mailed or delivered to

AMERICAN INSTITUTE PUBLISHING CO., INC.

135 Cedar Street New York, N. Y.

RUMFORD PRESS
CONCORD. N. H.

A SERVICE TO BOOK BUYERS

For the convenience of members and other accountants the American Institute of Accountants has established a bookshop and mail-order service through which technical books of all publishers are available for sale at regular prices.

The necessity of sending separate orders to the respective publishers of books and magazines which may be desired can be avoided by ordering through the central agency of the Institute.

Visitors are welcome at the bookshop on the street floor of the building at 135 Cedar Street, New York.

American Institute Publishing Co., Inc.
135 Cedar Street, New York

OFFICIAL PUBLISHERS AND BOOK SELLERS FOR THE
AMERICAN INSTITUTE OF ACCOUNTANTS