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# The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

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A. P. RICHARDSON, *Editor*

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## EDITORIAL

Looking Out to Sea      It is the daily habit of most of us to climb the stairs of the watch-tower and gaze out to sea in hope of discerning a sail of the argosy of good times for which we have waited long and not altogether patiently. A good many of us have little else to do except to search the horizon. We used to talk of the day when our ship would come in, but now there is a change and we say: "if our ship comes in." Rumors have come to shore that the fleet of commerce was approaching, but the adverse winds of fear and doubt have intervened, and the ships are still below the sky line. Statistics, emanating from many sources, are as contradictory as they well can be. Government agencies utter bland predictions and speak glowingly of the signs of prosperity. The financial markets profess to be able to see little to augur improvement. The great automobile industry is, comparatively speaking, thriving. Car loadings, bank clearances and other traditional measures of activity fluctuate like a barometer before a storm. It is possible to find statistical authority for almost any kind of prophecy, and it is difficult to form any opinion sufficiently definite to be used as the basis for investment or expansion. In some parts of the country, notably the south, the stream of federal relief has created a buying power greater than normal. To some extent the same condition prevails in the agricultural west. Around the industrial centers, with the exception of Detroit, there is a sense of grave insecurity. The dread of what may happen in these days of various experimentation, the faintness of the hope that congress

may assert itself and prevent unwise pursuit of the trial-and-error method, the increasing effect of prolonged depression upon the minds of men—these are the things which stand in the way of progress. It is probably safe to say that out of four men whom one may consult three will be positively pessimistic and one mildly hopeful. The estimates of unemployment are not even approximately accurate. They differ widely in accordance with their sources. It is undoubtedly true, however, that the number of unemployed in America today is at least three times the average of ordinary years. Is it, then, any cause for wonder that we can not espy the coming of the argosy of prosperity?

**A Little Hope on the  
Horizon**

But there are signs and omens which may induce a hesitant spirit of cheer. On April 8th the council of the American Institute of Accountants held its regular semi-annual meeting in New York. Representatives of all sections of the country were present. These men should be as well qualified as any one to report upon the general conditions of business in their several districts. With few exceptions they expressed the belief that there was a marked betterment. They said that their own offices were busier during the past few months than they had been for three or four years, and they also stated that the condition of clients' business was much improved. Companies which had been operating at a loss were now described as "out of the red," and the margin between cost and revenue was said to be substantial in many cases. There is a story current in New York of an auditor who was about to examine the accounts of a company and found that they were kept in red ink. The president, in reply to an inquiry by the accountant, said, "We have not made an actual loss but we happened to have plenty of red ink." The accountant inquired why the company did not purchase some black ink, to which the president replied: "If we did that we should be in the red." The popularity of this story indicates clearly the trembling condition of many a business. Now, according to the members of the council, the companies that are meeting with any success at all are earning discernible profits. People are tired of depression. They seem to be a little desperate. Probably if the causes of fear were removed there would be a quite material increase in the volume of business. The fact that there is in the minds of representative accountants an assurance of improvement

in spite of obstacles and fears shows that business is ready to be up and doing. The NRA and the AAA are very sick—and people are sick of them. Some feeble echo of them may reverberate for a little while, but their pernicious effectiveness is past. The last place in the world to recognize the approach of better days is Wall street; and it can not truly be said that there is much optimism in that hub of finance at present—but Wall street is not America. It is merely the most sensitive part of the whole body politic. Its existing nervous tension is bad for the whole country, but, like most highly temperamental creatures, Wall street can jump from the depths of woe to the heights of happiness with a rapidity that a more staid and lethargic community could never equal. What the accountants report about the conditions of business is, we believe, the most hopeful sign that good times will return some day and that the day of their return may not be very far away. Let the government of the United States indicate an earnest and honest desire to stop foolish interference with the natural course of business; let there be a promise definite and undeniable that the promotion of prosperity shall be the first purpose of the administration at Washington, and then—who knows?—perhaps the good day will dawn quickly.

**A Prosecution Thrown  
Out of Court** *The Accountant*, London, of March 9,  
1935, contains a report of an action  
against a prominent firm of accountants

in England for damages for alleged negligence in dealing with income-tax claims on behalf of certain merchants. This case is of importance to accountants throughout the world, because it brings forward clearly a fundamental principle which is often ignored or forgotten. The case was heard in high court before an official referee and was suddenly stopped on the third day of the hearing. The details of the case are unimportant to us in this country. In brief, the plaintiffs' allegation was that the defendants failed to make certain claims for deductions on account of losses and certain other claims for adjustment of taxation, with the result that the plaintiffs engaged another firm to examine the accounts and make applications for refunds, *ex gratia*. For the defense, negligence was denied and there was a counter-claim for sums alleged to be still due for services rendered. When the case was called, counsel for the plaintiffs said that as the result "of anxious consideration of the case" the court would not be

further troubled. The proceedings were being stopped, not because of any financial considerations, but because the plaintiffs had been advised that there was no reasonable probability of making good the charges of negligence against the defendants. He (counsel) wanted to convey that fact to the defendants and also that the plaintiffs were quite satisfied that there was no negligence upon the part of the defendants in dealing with the matters entrusted to them. "He hoped he had omitted nothing in complete exoneration of the defendants of any charge of negligence and, above all, he wanted to say that there had been no suggestion of fraud and no suggestion that defendants had been guilty of any impropriety of any kind. No stigma of any kind was intended to be cast upon the defendants, and, having regard to the eminence of the firm, nobody was likely to think that there could be any. Therefore the action would not be proceeded with and the plaintiffs assented to judgment for the defendants on claim and counter-claim with costs." Counsel for the defendants said that "the case was a matter of very great importance to his clients because they were one of the most eminent firms in a great profession and the mere fact of an action for negligence having been brought against them was damaging." Counsel for the defendants then proceeded to draw particular attention to the vital element of this whole case. He said that the allegations were incompetence and want of skill, and the partners in the firm had decided that whatever the action cost them they must fight it to a finish. They wanted to make it clear that actions of this sort could not be lightly brought and that, even if it involved the outlay of thousands of pounds, they must fight. The official referee, when the case was withdrawn, said that as far as the matter had gone he had not seen the slightest ground for the suggestion that the defendants had acted without due care or had done anything in the slightest degree to forfeit the confidence which the public and the taxing authorities had in their ability and integrity.

**Strike Suits Should  
Be Defended**

There have been many cases in which accountants have not fought back, as they should have done, when strike suits have been instituted against them. There is a sort of business man, aided and abetted by a sort of lawyer, who has attempted to make the accountant a kind of whipping boy for business. This has been partly due to the fact that the account-

ant has been insufficiently articulate in the assertion of his rights. He has sometimes seemed to wear a semblance of humility, for which there was no possible excuse. In this English case, involving a very minor matter, one of the largest firms decided to make an example of the plaintiffs. We do not know the background of the case, but, if one may judge from the report from which we have quoted, it appears to have been nothing more than a strike suit or the result of poor advice from another accountant. Whatever the motive of the prosecution may have been, it was obviously ill-advised in the opinion of counsel on both sides and of the official referee.

**The Effect of  
Blackmail**

During the last two or three years there has been a slight decline in the prevalence of strike suits against accountants, but there are still far too many. This is not intended to imply that an accountant should not be held responsible for wrong doing or for gross negligence, but the truth of the matter is that a little while ago there was an epidemic of attempts to hold the accountant responsible for things of which he had no knowledge and with which he had no direct association. Some of these cases were settled out of court by the payment of compromise damages. Some were tried and thrown out of court. Some were settled by arbitration. But it is indubitable that many a claim for which there was no justification whatever has been paid in order to avoid undesirable notoriety and the annoyance incident to defense. Nobody likes to be haled into court to answer charges which indicate incompetence or worse, and there is temptation to pay small amounts of blackmail in order to dispose of troublesome prosecution; but we believe that every accountant owes a duty to his profession to stand four-square upon his rights and to fight with every lawful weapon every attempt to extort tribute by unscrupulous lawyers and their equally unscrupulous clients. A few incidents like that to which we have referred would afford salutary evidence of the strength of the position of accountancy. It is a great profession and it plays a part second to none in the business world today. It offers, therefore, a butt of attack to every blackmailer who can possibly construct a specious plea. If, however, every member of the profession will carry his little share of the burden of defense whenever unjust attack is made, the force of assault will be dissipated. On the other hand, every account-

ant who yields to the demands of the blackmailer makes it harder for the rest of the profession and encourages the evil activities of extortioners.

**Lawyers and Accountants in Minnesota**

The legislature of Minnesota recently enacted a bill "for an act to clarify, re-arrange, consolidate and revise the laws relating to probate courts, etc., to establish a probate code and to repeal laws inconsistent therewith." The act was signed by the governor and is, therefore, the law of the state. There are many features of the act which are important and some of them novel. The one which attracts the attention of accountants concerns the appointment of an auditor. Sections 22, 23 and 24 read as follows:

"The court may appoint an auditor in any matter involving an annual, partial or final account, or the amount due on a claim or an offset thereto. Such appointment may be made with or without notice and on the court's own motion or upon the petition of the representative or of any person interested in the estate or guardianship.

"The auditor shall have the same power as the court to set hearings, grant adjournments, compel the attendance of witnesses and the production of books, papers and documents, and to hear all proper evidence relating to such matter. He shall report his findings of fact to the court.

"The auditor shall be allowed such reasonable fees, disbursements and expenses as may be determined by the court and shall be paid by the representative as expenses of administration or guardianship or by the person applying for such audit as the court may determine."

**An Example for Professions Elsewhere**

So far as we are aware this is the first enactment in the United States to convey such broad powers to the auditor in a probate case. It follows, in a general way, the provisions of the English acts relative to the same subject. We understand that, in the preparation of the draft of this act, accountants were called in to cooperate with the representatives of the bar, and the result is an act which can be approved by the members of both professions. This incident in Minnesota affords a useful precedent for similar cooperative efforts between accountants and lawyers throughout the country. There has often been too much unwillingness by members of the bar to consult accountants in the preparation of bills which vitally concern the practice of accountancy. The

effect has naturally been the enactment of bills which were undesirable and occasionally absolutely unworkable. Probably no legislature would dream of drafting a bill affecting the medical profession without inviting the assistance of medical practitioners or the medical societies, yet it has been quite common to legislate on technical accounting subjects without the advice of accountants and without the least understanding of the technique involved. The accountants and lawyers of Minnesota are to be congratulated upon the spirit of coöperation which has produced a greatly improved code and has also set an example to the rest of the country.

**The Biennial Peril  
to Accountants**

During the past winter most of the state legislatures have been in session, and, as usual, there has been a mass of legislative attempt to alter the laws governing the certification of public accountants. Every two years the profession passes through a period of peril, lest uninformed or malicious attempts to interfere with the proper regulation of the profession be made and succeed. The profession has had to spend an infinite amount of time and large sums of money to save itself from injurious laws. It has had to fight hard and long to uphold such standards as have been set in the past; and we suppose that the condition will not be altered in the near future. It seems a thousand pities that this should be so, but so long as a few men with private ambitions to serve can gain the ear of legislators, they can be counted upon to seek the overthrow of proper regulation. This year, fortunately, few really bad laws or amendments have been enacted. The rest of the bills have been killed in committee, beaten on the floor or have failed to reach consideration at all. Probably, therefore, the net result of the year's legislative activity may be regarded as reasonably satisfactory. Of course, every one knows that the regulation of a profession should be entirely above political considerations, but facts are stubborn things, and so the profession of accountancy, like many other professions and trades, must be ever on the alert and must be prepared to spend and be spent to uphold standards.

**Chattanooga Chapter  
Shows the Way**

As every accountant, especially those outside the large cities, knows, one of the most difficult questions arising in practice relates to the audit of states, counties and municipalities.



For many years there has been a fairly consistent effort to impress upon political authorities the desirability of departing from the more or less traditional custom of calling for bids. Some progress has been made, but the situation is still far from satisfactory throughout the country. Where improvement has taken place it has almost always been due to the concerted efforts of accountants in specific localities who have insisted that there be engagement of auditors upon a proper professional plane. One of the most recent efforts of this kind is reported by the Chattanooga chapter of the Tennessee Society of Certified Public Accountants. Following is the text of a resolution adopted by that chapter:

"Since it is the expressed intention of the county judge of Hamilton county and the recommendation of certain legislators from Hamilton county that an audit of the books of Hamilton county be made, this chapter desires to place itself on record as follows:

"1. That the audit should preferably be conducted by certified public accountants of Tennessee having no office in Hamilton county, Tennessee, which position was enunciated in former resolutions of this chapter, and from which position the chapter does not recede at this time.

"2. That if the audit is to prove of real value it should be conducted on a per-diem basis, without any restrictions as to the time involved or the scope of the work to be covered.

"3. That all accountants engaged on this assignment should have two years or more of public accounting experience.

"4. That the accountants employed should be given full authority within their discretion to examine any and all accounts and records pertaining to such audit and to have full access thereto.

"5. We suggest that the county court, by appropriate resolution, authorize and empower the four judges of Hamilton county named below to employ the certified public accountants to make this audit; Judge J. Lon Foust, Judge C. W. Lusk, Judge L. D. Miller and Judge Oscar Yarnell.

"6. That a sufficient sum should be set aside in escrow from current revenues to assure prompt payment of the accountants' fees.

"7. That there should be no submission of any preliminary report during the progress of the audit, either oral or written, and that all information relative to the accountants' findings should be deferred until the completed report shall have been delivered.

"8. Since it is apparent that the members of the county court or the judge of the county court and certain legislators desire the appointment of local accountants, it is further agreed by the members of the Chattanooga chapter of certified public accountants

that no member shall submit an individual bid, but should any members be selected by the designated authority, their fees would be as follows: certified public accountant in charge \$50 per day; certified public accountant assisting on the audit \$25 per day; non-certified accountant employed, \$20 per day. Not more than eight hours shall constitute a working day. Payment for services rendered shall be made promptly upon presentation of a bill every fifteen days.

"9. The members of the chapter, realizing the great importance of this audit, hold themselves in readiness at any time to render such services as they may, in a consulting capacity, to whoever may be employed to do the work.

"A copy of this statement shall be furnished to the judge of the county court and the press."

Several of the paragraphs in this resolution will excite the envy of accountants who have felt the effect of conditions which the resolution attempts to overcome. The accountants of the Chattanooga chapter are to be commended upon the wisdom of suggesting that an accountant from some other part of the state be engaged. This example of unselfishness is quite extraordinary. The provision that fees shall be paid when due is a distinct novelty. The scale of fees named indicates that accountants of eastern Tennessee are not sympathetic to the opinion of a few accountants elsewhere who believe that work should be done even at a loss.

## Educational Browsing

BY A. C. LITTLETON

In his recent article in *THE JOURNAL OF ACCOUNTANCY* on "Education for Professional Accountants," Lewis A. Carman includes "browsing" as a part of his program for college students preparing for an accounting career. This mention of browsing at once raises the thought that such a method of making the acquaintance of subjects of general or cultural interest is susceptible of considerable expansion.

But since Mr. Carman's article was inscribed to *Dear Professor*, it should perhaps be stated at the outset that I am not the person whose questions inspired that article. I wish that I were, for it would be a source of great satisfaction to have been associated with so sound a presentation of such an important educational problem. Yet that salutation offers a tempting precedent. I think I shall yield and answer in kind by creating the fiction of writing here as if to a former student.

*My dear Carman:*

So you did, after all, draw your trusty pen and invade the islands of curriculum making. We professors have always considered this area mandated to us, you know. But I guess we might as well confess that we have not done all we might to bring the territory up to date. You have marshalled your forces in excellent fashion, and I can see now that we must join forces—teachers and practitioners—to make a combined assault upon the hinterland. I am sure, therefore, that you will understand that any criticism here made of the details of your expedition still have this joint objective in view.

No doubt it is by design that you allot a good deal of time to auditing, practice technique and report writing. Is enough suitable text material available for all of this? If each of us had only a few students on the other end of a log. . . . But as it is, large classes must have text books. Please prevail upon your professional brethren to give us some deeply intensive professional treatises. We need many books which are more specialized than "all of the principles of all of the accounts."

May I say, too, that I think you are far too pessimistic about "economic science." You have been reading somewhere that we have had, or are having, a depression. Now haven't you? And you reflect the current confusion of tongues. We all need a little more perspective. We can get it by waiting some years longer and then looking back, or we can shut our windows and re-read Alfred Marshall's *Principles*.

Anyway, economics is not a science; it is a philosophy, and every philosophy is argumentative. That is the reason, I suspect, why engineering students do not often take economic courses as electives. "How can you ever tell when you are right?" one of them asked me once. I told him that economists didn't know when they were right, but that they always keep a straight face so everyone will think they think they know they are right.

Do you really believe your nine hours of economics is enough for a young man about to be precipitated into this argumentative world? I agree that he can do little to defend himself from adverse effects, even with the best knowledge of economics. But the better he understands the busy buzz all about him, the better he will be able to see into and behind the accounts he audits. His clients' affairs are carried on in the midst of economic activities and economic arguments, and the influence of these on him and his business is inescapable.

You allow only three hours for business law and three for corporation finance, which rests very much upon a legal foundation. Is this enough of the principles of law for one whose whole professional life is to be colored by concepts drawn from the law and corporation practices? Accountants need more law, even if it is ever changing, and more finance, too. We can not escape law any more than we can avoid economics. Perhaps one could shut his eyes and ears to both, but few of us are so fortunately situated as to be able to continue to do so for more than the length of a two-weeks' vacation. Certainly he could not do so and still be a practising accountant or a professing professor. Well, then, we ought to give the boys who are thinking of accountancy enough of both economics and law that they may be able at least to keep their fingers out of their ears while they practise.

Are you still listening? The professorial voice is so conducive to a drooping eyelid. But the bouquets are coming; the bricks have been cast.

One of the best things about your program is that all divisions

of the subject matter are represented throughout the four years. Some people prefer to give over the first two years to general and cultural courses in arts and science and to concentrate upon practical work in business, accounting and law in the last two years. But this plan has always seemed to me to blink several outright facts: (1) that a good deal of the material studied in the last two years is also quite "cultural," (2) that intellectual discipline—an important cultural element—can be obtained from any well-presented subject matter, (3) that much accountancy instruction must by its nature be sequential and can not therefore be adequately studied if too compactly presented. There seems to be very little advantage in trying to make the first two years "cultural and disciplinary" and the last two years, "utilitarian and practical." So I agree that it is much better to spread all four elements throughout the four years. Certainly they are all well intermingled throughout later life.

One of the outstanding and most commendable features of your program is the stress laid upon writing—"writing for the entire four years," as you say. Almost half of the time that you recommend for writing, however, is for "report writing," presumably audit reports. I endorse the writing but doubt the practicability of devoting so much of it to narrowly professional matters. The basic material provided for the student will be cold, printed problems and exercises which will be lacking in the stimulation coming from figures tested and assembled in the field. And remember, too, that the student has had very little practical experience which will enable his imagination to picture his printed problems in their natural setting.

The larger objective of practice writing is to develop a facility for expressing the ideas one has in mind—I like very much your phrase "to re-create in the mind of another." To do that takes clear thinking. Even if one never expected to write audit reports, he should write, write, write for the sake of the oil of clearness which writing and re-writing pours over the thinking process. Less time devoted to audit reports and more to general writing would not be detrimental. But audit reports should not be ignored entirely.

You have not linked reading and writing directly together. But I'm sure it is in your mind, for you make a strong point in favor of browsing. And there, in my opinion, you ring the bell again. To write, one must have ideas to put down; from that point on writing is merely choosing words to clothe the ideas

suitably—much like choosing socks and ties to harmonize. To get ideas one must add experience to imagination. Reading offers vicarious experience and furnishes material for a discriminating imagination. As an introduction to actual experience, therefore, reading is well-nigh indispensable.

But isn't the program you outline, including browsing, a rather ambitious one for young men between 17 and 21—the age of distractions and attractions? You remember how important athletics, dating and campus activities were when you were in college. Well, they still are. Most students do not get enough sleep as it is; and they might find browsing slipping over into drowsing.

I am for browsing; but when to browse, that is the question.

Now here is my suggestion, and I am serious about it. You yourself say that many of the cultural subjects in your list could be absorbed without formal class-room instruction. And you mean, of course, absorbed well enough for accountants. If you are going to be a philosopher, you had better take formal classes in philosophy—there probably is more to it than may appear on the surface. "Learn a lot about something and something about a lot," makes a pretty good motto. Browsing fits in nicely with the last part. That's a good way for an accountant to broaden his intellectual interest. But when?

Frankly, I am a bit skeptical about the theory that college days are the best time to browse up enough culture to last the next forty-five years of an active life. I suspect it is largely a life-long task. Let's start the boy out on it; give him the technique of browsing, so to speak, lead him to taste its delights. But let him understand that he must go on from there.

Some elements of culture he can not learn from books, anyway. Culture which is *generosity* is more apt to germinate on the athletic field; culture which is *tolerance* is more apt to rest upon close associations within a large family at home or its nearest equivalent at college, a fraternity; culture which is *kindness* probably derives from some sweet old grandmother, if not farther back in one's ancestry. There is a lot in culture which you and I can not do much about directly and personally.

But intellectual interests can be stimulated and directed in college courses and in college browsing, and the faculty of appreciation can be uncovered and nurtured a little. In college with all of the required courses, along with the distractions and attractions aforesaid, there is time only for a beginning. After college—

how the years stretch out ahead. That is the time to make the twenty-six hours that you allot to cultural subjects look like a drop in the bucket. No one can learn a little about a lot in twenty-six hours or any other reasonable amount of time which a man in college could find.

But afterward—even if one used only the one night a week his wife would let him off from playing bridge—why, in forty years there are 2,080 weeks. But let's be reasonable—say two evenings a month—480 months—there are loads of worthwhile books that you can read in two evenings if they are not required reading for some college course or other.

Well, if you can't pledge a book every month, just pledge those with thirty-one days; they are longer than the others. That still leaves over 250.

Let's assume that you are a few years out of college and blessed with a good wife and a good job—a double prize. Now is the time to open the pasture gate and browse all over the field of broad intellectual interests. This is going to be your liberal education. It is going to continue for a long time and parallel your continued professional education. It goes without saying that you are going to read the important new books and the current literature of your profession. You can use the months with less than thirty-one days for this.

The list of general subjects that you give is a good start. But I am going to do what you declined to do—elaborate.

There are two books I would want you to read first—a sort of introduction or preface. They are: Martin, *The Meaning of a Liberal Education* and Wiggam, *The Marks of an Educated Man*. After you have read the library copies, I very much suspect that you will get copies of your own. You are sure to want to re-read many sections at irregular intervals.

You mention historical geology. If you will just add world geography, I will go along with you. There could hardly be a better next step.

One of the most desired outcomes of a system of delayed educational browsing is that it brings the experimenter into contact with some subject matter or other which he can gradually make into his personal hobby. It might be *The Geography of the Gulf of the St. Lawrence*, *The Glacial History of the Great Lakes*, or what not. It is amazing the fun there is, for example, in hunting up old maps which reflect the ideas that the early explorers had of the

St. Lawrence country and the hinterland of rivers and lakes which the Indians tried to describe to them. It's fascinating to explore dusty old geological reports for the scientists' maps of the way the Great Lakes were united and divided as the last great ice sheet slowly retreated.

But we must get on. Now to lay some other broad foundations. You mention history of civilization. Very well, try your teeth on some of the following: Newman, *The Nature of the World and Man*; Wells and Huxley, *The Science of Life*; Dorsey, *Man's Own Show: Civilization*; Keller, *Man's Rough Road*; Van Loon, *The Story of Mankind*; Wells, *Outline of History*. Most of them are in some dollar-series or other. Or ask for suggestions at your public library. If you know someone giving "orientation" at a university, he could give you many other suggestions from which to choose. By the way, don't depend too much on what I said about "one book in two evenings" when dealing with this group. Some of them will make more than two big bites.

Here's another item I nearly forgot. For the ultimate in concentrated historical perspective get hold of *The Histomap*, if you can. On one sheet it pictures 4,000 years of the ebb and flow of changing civilizations in such graphic contrast that you can fairly feel your sense of national and contemporary superiority shrinking down to sensible proportions.

Next I would place economic perspectives. The little economics included in your program of prescribed subjects is, as I have said, rather inadequate. If browsing after college is to be really liberalizing, it must include reading in economics. Incidentally this particular reading will also help to make a better professional accountant. But even if it did not, it would still be very much worth while as general education. Our country is pre-eminently devoted to business; we possess an unusual flair for mechanics and invention; and America once was the marvel of the world in industrial productivity and high standards of living. We have slipped, it is true. But we shall catch our stride presently, for the will to do is going to reassert itself; the new technique will be found. In such a country, past and future, can a man be liberally educated without a reasonable economic perspective?

Choose among the following: For general background, Toutain, *Economic Life of the Ancient World*; Weber, *General Economic History*; Day, *A History of Commerce*; Rogers, *The Economic Interpretation of History*. For industrial developments, Gras, *Industrial*



*Evolution*; Polakov, *The Power Age*; Mumford, *Technics and Civilization*; Annals of the American Academy, *The Second Industrial Revolution and Its Significance*.

Top that off with a dessert of economic philosophy including the following ingredients or equivalents: Spahr, *The Economic Foundations of Business*; Commons, *Institutional Economics*. For coffee and cigars, I suggest some Americana, such, for example, as Beard's *The Rise of American Civilization* and his outline of American government called *The American Leviathan*; perhaps you would like to add Dewey, *Financial History of the United States*.

We've had the broad sweep of historical perspective with its ever-present urge to work inward toward illuminating details. You are sure to find side roads you will want to explore. But not much has been said about browsing to deepen one's appreciations. Here, I think, compactness, intensiveness is the key-note of the initial attack, because appreciativeness grows from a center outward like the widening circles about a stone cast into a still pool.

Do you aim at developing some appreciation of poetry? Choose one poet, and then only some selections from his work; but read and re-read yourself into his spirit. Concentrate; do not diversify for some time. I hold it better to know and really love one great poem than to pay lip service to half a hundred poets. Do you aim at appreciation of prose, of plot and characterization? Choose one author, one by preference already tested for you by time, and of that author only one or two tales in all. Make yourself master of them; outline the plot, study the personality of the principal characters separately, read something by way of background of the times or of the historical events involved and the historical persons. For example, you will find a fascinating area for study in Sir Walter Scott's *The Abbot*, if you work in this manner from the inside outward. If there is a chance that you will choose Charles Dickens, be sure and see the film story of *David Copperfield* and review it with an appraising and appreciative eye in the full text.

That for a start; if you expand this division of your browsing to excess, it is your own fault. It is not necessary to read widely here; you can grow in appreciativeness every time you re-read a real masterpiece.

The same principle is recommended for appreciation of music. Select a few phonograph records of great music. Get someone's

advice, but make your own choices—a few movements from the great symphonies, a few excerpts from Wagner, played by a great orchestra. Listen repeatedly, relaxed, while the smoke from your pipe lazily curls and eddies in the air about a shaded floor lamp. Don't let anyone tell you it is too "highbrow" to understand; you are not trying to understand—just appreciate, enjoy.

You'll soon be buying a few opera records, you will scan the radio program with an appreciative eye (it's not all jazz and crooning, really). Once in a while a talking picture will sing for you. You will be delighted with the songs—and surprised, no doubt, to learn that many of them are taken from standard operas. Pick out an opera or two from among the perennial favorites—ask some music teacher for help if you feel the need—get the complete libretto in translation; the drama is better appreciated from the words of the songs than from condensed summaries of the plot. Whenever the opportunity offers, hear those particular operas on the stage. Before long you will begin to catch glimpses of the synchronization of those two great mediums for expressing the emotions—music and drama. There is a thrill of appreciation awaiting you. And you have a much better chance of finding real appreciation at age 40 than 20. "Life begins at forty."

Well, I must make an end of what is, in fact, endless; so just a few more words.

Do you want to widen your intellectual interests to include something of science, philosophy, religion? Try some of these: Dietz, *The Story of Science*; Potter, *The Story of Religion*; Durant, *The Story of Philosophy*; and if you like Durant, try his *Mansions of Philosophy* also. More? All right. Darrow, *The Story of Chemistry*; Loeb and Adams, *The Development of Physical Thought* (Physics); de Kruijff, *Microbe Hunters*; Dewey, *Human Nature and Conduct*; Randall, *The Making of the Modern Mind*; Cotton, *Has Science Discovered God?*

Biography? Ludwig, *Genius and Character*; Holland and Pringle, *Industrial Explorers*; Law, *Modern Great Americans*; Wilson, *Great Men of Science*; and innumerable biographies according to taste.

Topical history? Groseclose, *Money: The Human Conflict*; Epstein, *The Automobile Industry*; Mottram, *A History of Financial Speculation*. Every field has its history. Choose, if you wish, architecture, electricity, law, medicine, music, drama, education, engineering, transportation, pirates, criminology, sculp-

ture, chemistry, steel, sugar, slavery, pre-historic man, et cetera, et cetera. Go as far as you like.

Present-day problems? Just a sample: Beard, *Whither Mankind?*; Berle and Means, *The Modern Corporation and Private Property*; Robbins, *The Great Depression*; Hall, *Government and Business*. Present-day problems seem, just now, almost unending. But do not, I beg of you in the interest of broad education, become too absorbed in them. Nor will you care to ignore them either.

Perhaps the best specific in this case is the right choice of current periodical literature. But that I leave to your own unfettered choosing. Only, browse about a bit before you choose. You can't read everything, you know, although it may seem from all this that I have been assuming that you could.

# Manufacture of Castings for Railroads

BY R. T. RISK

The following thesis attempts to give in some detail the results of research into that department of the steel industry which is concerned with the manufacture of miscellaneous steel castings for railroad cars.

## MANUFACTURING PROCESSES

Raw materials consist of the ingredients which go to make up steel. These are low and high carbon scrap steel, scrap wheels, pig iron, coke, limestone, manganese, silicon, etc. These materials are brought into the yard in cars by locomotive, where they are unloaded into numbered bins. Some cars are unloaded by hand, but most of them are unloaded by means of steam derricks. One "heat" usually consists of 50,000 pounds of material, exclusive of limestone, which acts as a flux, and tempering alloys such as manganese and silicon which are used in small quantities. The materials are loaded in pans which are approximately 4 feet long, 1½ feet wide, and 1 foot deep. Three of these pans rest on a small flat car. After the pans are loaded and weighed, they are shoved upon the furnace platform where an electrical charger picks up one pan at a time, injecting it into the furnace, emptying it and then withdrawing it.

The steel is made by the open-hearth process. The furnace has a large bed lined with fire brick and sand on which the charge is placed. By the aid of a regenerative heating system, a higher temperature is obtained than otherwise would result. Gas is used as fuel and is heated before entering the furnace by passing through a checkerwork of hot fire brick. The heated gas is passed into the furnace through a pipe, while air that has been similarly heated enters through another flue. The burning gas passes over the charge on the furnace bed and the hot gaseous product escapes through checkerworks which are a duplicate of those used to heat the gas and air. One set of checkerwork is thus raised to a high temperature by the hot combustion products, while the other is being cooled as it heats the gas and air about to enter the furnace. About every twenty minutes the direction of the gas and air is reversed by means of a system of valves, so that gas and

air pass through the recently heated checkerwork while the flame from the furnace passes through the one just cooled.

The scrap steel is placed on the bottom in order to protect it from the oxidizing action of the flame. The manganese and silicon are oxidized by the flame, while the iron is furnishing oxygen to consume the carbon. The process consumes from six to eight hours and is watched and controlled most carefully by the operator. Samples of metal are repeatedly taken from the furnace and examined to determine when the impurities have been removed and the carbon has been reduced to the desired amount.

While the heat is being made, the foundry is busy making molds with which to take care of the heat.

Patterns are brought to the foundry from the pattern shop where they were made from drawings and specifications furnished by the mechanical engineering department. There are two patterns for each casting, one for the upper half and one for the lower half. On top of the pattern is placed an iron flask varying in size to fit the pattern—the pattern forms the bottom and the iron flask the sides. Sand is packed into this frame on the pattern by means of air rammers or machines called sandslingers. The frame with the packed sand is then lifted off the pattern by means of an air hoist. Another crew of men is engaged similarly in making a mold for the upper half of the casting, which is called the cope, the lower half being called the drag. Cores are then inserted into the molds by finishers who secure them firmly by means of long wire nails. These cores are made by coremakers in the core department a day or two prior to use in the foundry. Cores are made by packing sand in core boxes of sundry sizes and shapes in accordance with the pattern of the mold which they supplement. Most of the cores are baked in the ovens until they become very hard before they are transferred to the foundry.

The two molds are then put together and set along side of others to await the tapping of the heat. When the heat is ready it is tapped into a large ladle supported by a 60 ton overhead crane. As soon as the heat has run into the ladle, the crane carries it to the first mold in a long line. The ladleman by means of a lever opens a small opening in the bottom of a ladle through which the molten steel runs into the mold. When one mold is filled, the crane carries the ladle to the next one and so on until the slag is reached in the bottom of the ladle. The hot castings are pulled out of the molds by means of chains from the cranes and carried

to one end of the foundry. This is known as the "shakeout." Here by means of pneumatic hammers all the sand is jarred loose from the center of the casting. The castings are then loaded on a flat car and carried to the cleaning and machining department. Here they are loaded on small flat cars and run into annealing furnaces, where they are heated to a certain temperature in order to temper the steel. When the castings are taken from the annealing furnaces they are ready to be cleaned and machined. Rows of chippers with pneumatic chisels cut off all rough edges. Here small cracks are welded and castings not too badly warped are straightened by presses. Inspectors then examine the castings which, if they pass inspection, are weighed, sorted and placed on a track. Here they are examined by inspectors representing the railroads who are the purchasers of the castings.

#### ACCOUNTING RECORDS

The accounting for the head office is divided into four departments classified as the voucher division, the billing division, the sales-ledger division and the general division.

In the voucher division a voucher-record system is used to audit and record accounts payable. Vouchers are of two kinds; those prepared by the purchasing department covering materials received at the various plants, and those prepared by the voucher division covering miscellaneous supplies and expenses and general office expenses.

When an order for material is placed with a supplier an acknowledgment of acceptance is required by the purchasing agent. When this is received it is checked against the order as to price, quantity and terms, and, if in accord, it is filed and kept for one year to be available should any controversy regarding payment arise. When the material is shipped, an invoice in duplicate is mailed to the purchasing department. The invoice is entered in a purchase ledger and also, if a carload lot, in a carload record. The invoice is then sent to the works for approval as to receipt of material, quantity and quality. The purpose of the purchase ledger is to record the date invoice is mailed to the works, the date returned and the date vouchered. The record is also used for checking shippers' statement of accounts.

The carload record shows shipper's name and address, date of order, order number, material, quantity ordered, price, F. O. B. point, terms, delivery date and analysis. This record is to guard

against error in delivery, over-shipments and the misapplication of material against the order.

Invoices, having been approved by the works, are returned to the purchasing department to be checked and vouchered. From here they are sent to the accounting department to be audited and recorded in the vouchers-audited record. The vouchers then go to the treasury department for payment, where payment is entered in the cashbook.

Works miscellaneous invoices are vouchered by this department after reference has been made to the works miscellaneous orders and copies of contracts. The voucher is sent to the accounting department for auditing and then is entered in the vouchers-audited record.

Postings to the general ledger are made from the vouchers-audited record.

Freight bills are paid at the various works by cheques drawn on a common freight account maintained at one bank. That account is always kept at a fixed amount. Upon receipt of copies of freight vouchers from the works each day, a reimbursing voucher is prepared in favor of the bank in which the freight account is deposited.

The most important work of the billing division is to invoice and record all sales as covered by shipping reports from the various plants. Upon receipt of a customer's order by the order department, it is referred to the sales engineering department for pattern numbers, etc. It is then referred to the sales department for prices and F. O. B. points. The order is then acknowledged to the customer and two carbon copies of the orders are compiled.

One of these is forwarded to the works, and from the other copies are made for general office use. One copy is sent to the accounting department with prices and F. O. B. points and with a copy of the acknowledgment attached. One copy is sent to the traffic department for routing; one copy to treasury department for credit purposes which is returned to the order department; one copy to sales department; and one to the order department.

The accounting department, on receipt of orders which are reported by the order department by order numbers, checks the list to see if all orders are attached. Prices and F. O. B. points are checked with the acknowledgment, and then the orders are filed in binders according to the order numbers.

Shipping reports are the basis of all charges for materials sold. These reports are mailed to the head office the same day that materials are shipped. Shipping reports, on receipt by the head office, are given to a pricer who checks them against the order. The price and F. O. B. point are then inserted, with other information such as account number, number of invoices, who is to receive copies, etc. The shipping report is then forwarded to a checker who checks them against the orders as to prices and F. O. B. points. All shipping reports, on which freight charges are prepaid or those shipped "collect", for which company is liable, are sent to the traffic department, where the freight rate covering the liability is inserted.

The comptometer operator then verifies the total pieces and weights and makes the extensions showing the amount charged to the customer and the necessary amount of freight reserve.

Shipping reports are next invoiced to the customer in accordance with the billing information. Invoices are then separated from the carbons by the checker and then checked to the shipping report. Quantities, amounts, prices and extensions are checked by a comptometer operator who also verifies the freight deductions and reserves. Invoices are then mailed with bills of lading and inspection reports to the customer. Shipping reports are then separated from the sales ledger copy of invoice. The shipping reports are listed by adding machine as to amount, freight reserve, out freight, miscellaneous sales and prepaid freight, and are summarized on a form. The same procedure is followed in respect to sales-ledger copy of invoices, and a summary is made which should balance with the summary of the shipping reports. The sales-ledger invoices are then sent to the sales-ledger division. At the end of the month a general sales summary is made up from the daily summary of sales taken from shipping reports. Entries are made in the general ledger from this summary.

The work of the sales-ledger or accounts-receivable division consists of posting all invoices made from shipping reports received from the various plants. The details of the work of this division are separated into three classes of accounts: accounts receivable, railroad claims and bad debts.

Railroad claims consist of company claims against carriers for overcharge in freight rate, error in weight or material lost in transit. Claims covering outbound shipments, which are filed



by the traffic department, are credited to the customer's account and debited to an account "railroad claims". Claims filed on inbound shipment are held in file and not entered on records until paid, when the proper works account is credited with the payment.

Invoices for one day arriving from the billing division are sorted alphabetically and divided according to the various sales ledgers by the bookkeeping machine operators. The invoices are then posted to the individual customers' accounts. The total of invoices posted as shown by the machines must tally with the summary of invoices which accompanies the invoices from the billing division. The total is then posted to a control sheet. A summary is kept of the total invoices posted each day and at the end of the month the total charges to customers' accounts are posted to the general ledger.

Remittances arrive in the ledger division from the treasury department, accompanied by a list of the customers and amount of the cheques remitted.

A remittance slip is made up for each customer in duplicate, showing the amount due, freight deducted and the net amount received. The original remittance reports are returned to the treasury department, attached to the individual cheques. Postings to the customers' accounts are made from the duplicate remittance slips. When the cheques have been returned to the treasury department they are entered in the cashbook. Each day the total cash posted to the sales ledger is checked with the total deposits for the day.

At the end of the month monthly statements are made up in triplicate, one copy going to the customer, one to the treasurer and one being retained by the bookkeeper.

The control ledger is kept by the head of the sales-ledger division. When a day's sales have been posted, the total of sales posted to each ledger is posted to the control account in that ledger. The same applies to total cash remittances, credit memoranda, journal entries, etc. The grand totals of the day's sales, cash remittances, etc., are then posted to the control ledger. The control ledger at the end of the month should balance with accounts-receivable account in the general ledger.

In the general division the financial statements of the company, such as the balance-sheet, profit-and-loss statement, application-of-funds statement, etc., are prepared monthly.

Here journal entries are compiled from various works forms in addition to journal entries prepared by the billing, sales-ledger and voucher divisions. The journal entries of the different divisions are submitted to the head of the general division, whose duty it is to scrutinize them and satisfy himself as to their correctness, after which they are sent to the comptroller and assistant comptroller for their approval.

The theory of accounting between the general office and works makes it necessary that for each debit to general office account on the works ledger a corresponding credit entry be made to works ledger account on the general ledger. These two accounts should always be in agreement except for adjustments in transit between the head office and the works.

In this department journal entries are also compiled from various reports received from the different works. For example, the total cost value of salable, shop and exhibition castings produced during the month obtained from monthly summary of cost of production reports received from plants is charged to finished-products account and credited to works ledger account. The cost of shop castings is charged back to the works because it is an element of cost, while the cost of exhibition castings is charged to an exhibition expense account. Other journal entries made up in this division in reference to the works concern miscellaneous shipments and charges, inter-works sales, workmen's compensation expense, capital and other general office expenses and various adjustments in inventories, sundry reserves, etc.

Records of physical properties and their reserves for depreciation are kept in the following manner:

A separate equipment ledger is maintained for each plant. Each property group has a ledger sheet or sheets on which are entered a description of the equipment, date installed and cost. All similar pieces of machinery and equipment having the same rate of depreciation are grouped together. Provision on this record is made for annual depreciation estimate.

Changes in the respective property records are made annually from a report of additions and discards compiled monthly by the plants. Depreciation is based on a fixed rate in the property-record ledgers, but actual depreciation is taken on a tonnage basis. This rate is found by dividing the average annual tonnage for the past three years into the estimated depreciation per property record for the previous year. Depreciation is

then taken monthly by multiplying this rate by the tonnage produced.

No depreciation is provided in the current year for any equipment purchased or installed during the year, but it will be computed from the beginning of the subsequent fiscal year.

Only equipment costing in excess of a fixed sum is charged to a capital account. The cost of small replacements is charged to repairs. When a large replacement is made, which constitutes a decided improvement (such as a tile roofing replacing a composition one) the cost is charged to capital account.

The records kept at the individual works may be divided as to wages, stores and materials and accounting.

First, in respect to wages, clerks, department heads, foremen, etc., are on the salary roll and are paid twice a month by cheque. All other employees are on the plant payroll and are paid on either an hourly or a piecework basis. The salary payroll is kept by the confidential secretary to the works auditor. A cheque is deposited to the payroll account for the total amount of the payroll and salary cheques are made out against this amount.

Each employee rings a clock card on entering and leaving the plant. Each department has its timekeepers, and a service card is made up by these timekeepers for each man on the works payroll. This service card will give the number of hours the employee has worked, the rate per hour and the total remuneration for the day. If the employee is a pieceworker, the timekeeper will put on the service card the pattern number of the product on which the employee has worked, the number of pieces he has made and the rate per piece, which will give the amount due the pieceworker for the day.

The different departments which employ pieceworkers will have a list of piece-work rates for each pattern. This is usually made out by the department foreman and approved by the works manager. The time-office, which is under the supervision of the cashier, will have duplicates of the piece-work rates so that on the following day, when the service cards are turned over to the time-office by the various department timekeepers, the piece-work rates can be checked in order that workmen may not be overpaid.

The timekeeper in the general time office checks all hourly and piece-work extensions on the service cards. He collects the time cards of the employees daily. On the time card is a column in which he enters the number of hours from the service card which

the employee has worked the previous day. As he enters the number of hours he checks the time card to see if the rings show as many hours as are given on the service card. At the same time he checks the rate per hour as shown on the top of the time card with the rate used on the service card. For piece-workers, the time card has a money column in which is entered the amount of money earned by the piece-worker for the previous day's work. When the timekeeper has finished entering the service cards, he gives them to the payroll clerk who enters the hours or amounts opposite the various employees' names in a payroll book. At the end of the payroll period the timekeeper collects all the time cards for that period and employees are given new time cards for the next period. The timekeeper then calculates the number of hours each employee has worked, putting the total at the bottom of the time card and multiplying it by the rate to get the total amount due each employee. Piece-workers' cards are merely footed to obtain the sum due them. At the same time the payroll clerk is making the same calculations in his payroll book. The time cards then are checked with the payroll book. If there are any discrepancies between the two records, the service card must be looked up in order to determine which record is to be corrected. When the time cards and the payroll sheets are in agreement the payroll sheets are footed to get the total amount of the payroll. Cheques are made out from the time cards and checked to the payroll book. Employees receive their pay cheques twice monthly. When the employee receives his cheque he must be identified by his foreman and must sign his clockcard. The service cards when they leave the time office go to the distribution clerk in the main office.

All classes of labor in the various departments are assembled under separate account numbers for the purpose of controlling cost, e. g. 110 foremen, 111 clerks, 112 helpers, etc. The distribution clerk assigns the various account numbers from the description as shown on the service card. These labor charges are assembled under the account numbers which have been assigned and are posted to a summary of labor distribution by departments. At the end of each period these charges are summarized on a report of labor distribution, the total of which become a debit to cost account and a credit to payroll account. When the payroll is made up, there is a charge to payroll account and a credit to cash.

When the works require material or stores, the works supply agent requests the purchasing agent at the general office to place an order with a supplier for the materials or stores. When the order is placed the supply agent receives a copy of it from the purchasing agent, and this is his authority for receiving shipment. When the supply agent receives notice of shipment from a supplier he makes up a material-received report in triplicate, which contains the name of supplier, car number and initial, order number and description of material. The original, duplicate and triplicate are sent to the yard clerk to await arrival of shipment. When the car is received, the yard clerk weighs it and attaches a scale ticket to the material-received report, which is then filled out with the information required and the original is sent to the comptroller at the head office. The remaining copies are held until the invoice is received from the general office. When the yard clerk receives the invoice he approves it by placing on it a stamp of approval. The yard clerk then lists the approved invoices in triplicate, the original list going to the comptroller, the duplicate with invoices attached going to the purchasing agent at the general office and the triplicate with duplicate invoices to the cost clerk at the works. Postings to the works ledger are made from the triplicate list of approved invoices, inventory account being debited and general office account credited.

A book inventory is kept by quantities. This subsidiary ledger, or stock-pile record, has an account for each pile. All material received is entered in this record from the original material-received report.

All material going to the melted-metals department to make up a heat is weighed and entered on a heat report in triplicate, one copy going to the melted-metals department, one going to the works office and one being retained by the yard department. Postings are made to the various accounts in the stock-pile record from the heat report for materials used.

When stores are received a material-received report is made out by the storekeeper. The original is sent to the comptroller and the duplicate and triplicate are retained until invoices are received. The invoices are stamped "approved", and a list of approved invoices is then made up and the same procedure is followed as in the handling of material-received reports for bulk material. The postings to inventory accounts in the work ledger are also handled in the same manner as postings for bulk material.

This list of invoices also includes items of intangible nature such as purchased power, purchased water and service charges.

The subsidiary stores ledger is kept according to each class of stores received. This record is kept by quantity and value. All receipts are posted directly from the invoices and each class of stores is handled as a separate account. This subsidiary stores ledger should agree with the inventory accounts in the work ledger. An inventory is taken at the end of each month and any discrepancies discovered are adjusted.

All requisitions for stores issued must be authorized and signed by proper parties whose signatures have been registered at the store room. All requisitions are priced and valued from information taken from the subsidiary stores ledger. Stores-ledger accounts are then credited from the requisitions.

The bulk-material clerk compiles from the heat reports a summary of material used, on which are listed the quantities of materials by inventory accounts under the heading of the department which is to be charged. This report is then priced by the cost clerk, and after its extension it becomes the basis for posting the credits to the inventory accounts in the works ledger. Contrary to these credits will be a debit to the cost account. A summary of stores used is also compiled in a like manner from reports compiled in the storeroom from requisitions. This is used as a basis for credit postings to the stores-inventory accounts and for debit posting to cost account.

All miscellaneous charges, such as purchased power, water, etc., are charged to the works ledger account "Cost account, other charges." Subsidiary accounts to this control account are kept by departments, to afford a means of cost control. At the end of the month this account is closed into the cost account.

In order to prevent fluctuation in monthly costs caused by extraordinary labor and material costs, repairs to open-hearth furnaces, machinery, etc., a reserve is set up taking into cost a repair charge in proportion to production. A monthly credit to this reserve is based on a fixed rate per ton of production. The charge is made to cost account. As large repairs are made this reserve account is charged. Charges applicable to the current month, for which no invoices have been received, are charged to their respective accounts and credited to unaudited-bills account.

At the close of each month, labor, stores and material and other charges or overhead having been closed into the cost account and

the cost account in turn having been closed into the general office account, a trial balance is taken. This trial balance, with a statement of cost supported by various schedules giving the detail of the cost, is then sent into the head office. As explained in the discussion of head office accounts, this cost is charged into finished-castings account in the general ledger and works ledger account is credited.

After the works costs have been placed on the general ledger, the general division of the head office prepares a balance-sheet and monthly profit-and-loss statement, using the following forms:

BALANCE-SHEET—FORM

CURRENT ASSETS

Cash  
    Bank accounts (general office)  
    Works working funds  
U. S. government securities  
Accounts & bills receivable  
    Accounts receivable (customers)  
    Bills receivable and interest accrued  
    Accounts receivable suspense  
    Traveling expense funds  
    Advances out of works auditors' funds  
    Outward freight reserve  
    Returned castings reserve  
Inventories  
    Bulk materials and stores  
    Work in process  
    Finished castings  
    Total current assets

DEFERRED CHARGES TO OPERATIONS

    Sundry patents  
    Insurance premiums  
    General operating expenses

REAL ESTATE

BUILDINGS

PLANT

MACHINERY

TOOLS

PATENTS AND GOODWILL

    Less reserve for depreciation  
    Total

CURRENT LIABILITIES

    Accounts payable  
    Audited vouchers

*Manufacture of Castings for Railroads*

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Discount & royalty reserves  
T. B. D. freight  
E. B. A. deductions  
Out freight pre-paid reserve  
Unaudited bills (general office)  
Unaudited bills (works)  
Payroll accrued  
Works payroll accrued  
Unclaimed wages  
Bonus fund reserve  
Provision for federal income & other taxes  
Federal income tax reserve  
Corporation taxes  
Real-estate and personal property taxes  
Total current liabilities

SUNDRY RESERVES  
Furnace building reserve  
Metal flask renewal reserve  
Workmen's compensation reserve

CAPITAL STOCK  
Total

PROFIT-&-LOSS ACCOUNT—FORM

Gross sales  
Tons  
Per ton  
Deductions:  
Discount and royalty  
Outward freight  
Miscellaneous allowances  
Total deductions  
Per ton  
Net sales  
Per ton  
Manufacturing cost of sales  
Per ton  
Depreciation  
Per ton  
Expenses while closed  
Per ton  
Gross profit or loss from operations  
Per ton  
Selling expense  
Per ton  
Administrative and general expense  
Per ton  
Total  
Per ton



Net profit or loss from operations  
Per ton

Add: Miscellaneous income:  
Interest, discount and exchange  
Income from investments  
Miscellaneous P-&-L (works)

Total profits and income

Deduct:  
Interest charges on borrowed money  
Balance of profits and income  
Deduct: Reserve for federal income tax  
Net profit carried to surplus

The future of this phase of the steel industry is entirely contingent on the future of the railroads in this country. At the present time, the railroad industry is facing a crisis due to the general business depression prevalent throughout the country and the increased competition furnished principally by busses and trucks, vessels using the inland, lake, and coastwise waterways and by pipe lines. The railroads form the backbone of our transportation system and the services furnished by them are essential, but statistics show that the freight and passenger traffic of the railroads has failed to grow commensurately with other business.

## Participation Rights of Preferred Stockholders

BY L. L. BRIGGS

The terms of a preferred-stock contract may provide that after payment of the preferred dividend the holders of this stock may be entitled to share equally with the common stockholders in any further dividends that may be declared or that they may share in dividends declared after the holders of the common stock have received a dividend equal to that of the preferred. The preferred certificate may also prohibit further participation in profits after the holders have received their stipulated dividend.

When there is no provision at all in the preferred contract in regard to the disposition of earnings left after the preferred stockholders are paid their contractual dividend, misunderstandings may arise because the contract may be interpreted as limiting these shareholders to this amount or it may be interpreted as not having such a limitation. Most of the corporate instruments merely state that certain shareholders shall be entitled to a specified preferential dividend and contain no provision as to what shall be done with the balance of the surplus earnings available for distribution as dividends.

Some writers on corporation law and the leading legal encyclopedias state that unless the corporate instruments provide otherwise, preferred and common stockholders participate equally in any distribution of profits after both the preferred and the common shareholders have received a dividend equal to that provided for in the preferred contract. A careful study of the court decisions on the point leads me to the conclusion that this is not an accurate statement of the law in all jurisdictions. It is the rule that is followed in some states but it is not the law in others. The point is still unsettled in a majority of the states because it has not come before their highest courts. So far as I have been able to determine, the supreme court of the United States has never had occasion to rule upon it.

A review of the cases on this point discloses the existence of two distinct and conflicting rules both of which are broad enough to include any case where the corporate instruments contain no provision about participation of preferred stockholders in surplus profits. Some jurisdictions permit participation after the

common stockholders have received a dividend equal to the preferred while others do not allow such a division of the corporate profits.

Pennsylvania has taken the most definite stand in the matter and the decisions in that state clearly hold that the preferred shareholders may share, pro rata, with the holders of the common stock when excess profits are distributed. The case of first impression, *Fidelity Trust Company v. Lehigh Valley Railway Company*, was to the effect that all shares are equal except for the preference stated and that preferred stockholders have all the ordinary incidents of shareholders together with any preference specifically given. For three years the common stockholders had received a dividend equivalent to the ten per cent. paid to the preferred and the remaining surplus available for dividends was divided equally between the common and the preferred at the same rate per share on the par value. Later, however, the surplus was not large enough to pay the ten per cent. cumulative dividend on the preferred, and when a sufficient surplus became available the question arose as to whether the excess paid above the amount of the preference for the three early years could be charged against the preferred arrears of subsequent years. The court decided that it could not be so charged, on the ground that what the preferred had received in the way of dividends with the common in excess of its ten per cent. was a legitimate distribution of profits. Citing no authority the court said that "when each class of stock had been paid ten per cent., they were equal, and equally entitled to distribution of whatever remained in the fund applicable to dividend purposes."

*Sternbergh v. Brock* is the next Pennsylvania decision in regard to preferred participation rights. According to its facts, the preferred stockholders, from 1899 until 1907, received their stipulated dividends and no more, while all profits above these amounts were distributed to the common shareholders who received less than two per cent. on the par value of their stock but more than five per cent. on the amounts which they actually had paid. In March, 1907, a quarterly dividend of two per cent. (a rate of eight per cent. a year) was declared on both the preferred and the common stock. Sternbergh, a common stockholder, filed a bill in equity and claimed that the preferred stockholders were entitled to only five per cent. The contract had no participation provision. The lower court denied the injunction on the author-

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ity of the *Fidelity* decision and the case was appealed. In stating the opinion of the higher court, Justice Potter said:

“Where there is no stipulation in the contract to the contrary, the weight of authority clearly favors the right of preferred stockholders to share with the common stockholders in all profits distributed, after the latter have received an amount equal to the stipulated dividend on the preferred stock. In the absence of special provisions, the holders of preferred stock in a corporation are in precisely the same position, both with respect to the corporation itself and with respect to the creditors of the corporation, as the holders of common stock, except only that they are entitled to receive dividends on their shares, to the extent guaranteed or agreed upon, before any dividends can be paid to the holders of common stock.”

The supreme court of Pennsylvania, therefore, affirmed the decision of the lower court.

In *Englander v. Osborne*, the plaintiff's decedent owned shares of six per cent. cumulative preferred stock in a corporation. No dividends were paid on either the company's preferred or common stock until 1917, a period of nine years, when a dividend of fifty-four per cent., covering the current year and all arrearages, was declared and paid on the preferred, and at the same time a dividend of an equal amount was declared on the common. The plaintiff brought an action to restrain the payment of the latter dividend on the ground that the holders of common stock were not entitled to a dividend of more than six per cent. without sharing the excess equally with the preferred shareholders. On the other hand, the defendants claimed that the holders of common stock were entitled to receive dividends to an amount sufficient to make up arrearages in past years and to equalize the common and preferred stock before the holders of the latter were entitled to receive an excess above the amount of their fixed dividends and arrearages. The lower court restrained the payment of the dividend on the common stock, and the defendant appealed. In giving the opinion of the higher court, Justice Frazer made the following statement:

“We find nothing limiting the right of the preferred stockholders to the six per cent. dividend, regardless of the earnings of the company, and in the absence of such limitation the general rule is that such stockholders are entitled to share with the holders of the common stock all profits distributed after the latter have received in any year an amount equal to the dividend on the preferred stock. The priority of the preferred stockholders rests

upon the contract, and beyond the provisions of such contract they occupy no position toward the company different from that of the holders of common stock. When a dividend is declared, the former are entitled to share to the extent of their preference for the current year, and if there remains a sum more than sufficient to pay a similar dividend on the common stock, both classes are entitled to share equally in the excess. In the absence of agreement, expressed or implied, that dividends shall be cumulative, unpaid dividends in the past can not be claimed."

The supreme court concluded that the above principles had been properly applied by the lower court and consequently affirmed its decision.

Indiana seems to be the only other state clearly in line with Pennsylvania on this point. In *Star Publishing Company v. Ball*, the supreme court of that state, speaking through Justice Townsend, said: "The preferred stockholder is just as much a party to this venture as the common stockholders, and is entitled to all the rights of the common stockholders, except as modified by statute and contract." After dividends are paid on the common stock equal to those received by the preferred under their contract, the preferred may participate in additional dividends to any amount.

In a Georgia decision, *Coggeshall v. Georgia Land and Investment Company*, there is a dictum which conforms to the Pennsylvania rule. In this decision, Judge Wade said:

"Preferred stock takes a multiplicity of forms but usually possesses certain distinctive characteristics. The dividend may be either cumulative or non-cumulative; and unless the contract provides otherwise, preferred stockholders participate in the surplus profits, after the preferred dividend has been declared on the preferred stock, and an equal dividend on the common stock."

In an early English case, the house of lords held that after discharging all debts and liabilities and repaying to the ordinary and the preference shareholders the capital paid on their shares, the assets ought to be divided among all the shareholders in proportion to the shares held. This means, of course, that preferred shareholders would participate equally with the common in any surplus profits in the hands of the company.

Another English decision contains this dictum in the words of Justice Swinfen Eady:

"There is not any rule of law that shareholders having a fixed preferential dividend take that only. It is quite open to a company to distribute its revenue first in paying a fixed preferential

dividend; then in paying a dividend of like amount to the ordinary shareholders; and then dividing any surplus revenue of the year ratably between the preference and the ordinary shareholders.”

The latest English decision in point involves a company liquidation. In this it was held that where there is nothing in the articles to modify or to exclude the normal right of the preference shareholders to share in the distribution of the surplus assets, they were entitled to rank, *pari passu*, with the ordinary shareholders in such distribution. Justice Eve made the statement that:

“Nothing is said as to the distribution of any assets still remaining for distribution after the capital has been repaid, but in the absence of any provision to the contrary these assets—the joint result produced by the employment of capital contributed by both classes of shareholders—ought to be shared by the contributors.”

Now let us consider the status of stock dividends from the standpoint of preferred participation. If the voting control of the corporation is undisturbed and the right to share in assets upon dissolution is not impaired, and there is no contract to the contrary, the preferred may participate in stock dividends as well as in cash distributions under the Pennsylvania rule. In *Sterling v. Watson*, the voting cumulative preferred stock could be retired at the option of the corporation upon the payment of par value and accrued and unpaid dividends. Eight years after a twenty-five per cent. common stock dividend had been distributed equally to both common and preferred stockholders, the company decided to retire the preferred and sought to deduct the par value of the stock dividend from the total amount due to the preferred stockholders under their contract. The court denied the right to make this deduction on the grounds that the contract meant that the preferred dividends must be in cash and that the preferred shareholders were entitled to participate with the common in the stock dividend on the authority of the *Fidelity Trust* and *Sternbergh* decisions. According to Justice Elkin:

“When the preferred dividends are paid, and dividends out of the net earnings from year to year of an equal amount have been declared and paid on the common stock, then all of the stock, common and preferred, has the right to participate in the distribution of the surplus earnings upon an equal basis. . . . The principle is sound and maintained by the great weight of authority.”

The original and generally accepted understanding in business and financial circles is that after the preferred stockholders get their specified dividend they are not entitled to participate, and if the rest of the profits are paid out by the corporation in the form of dividends such distributions go entirely to the common stockholders. This is usually called the English rule.

The first time that the question of preferred participation rights appeared before the American courts was in *Scott v. Baltimore and Ohio Railroad Company*. According to the report of this case, the preferred certificates provided that the holders should be entitled to such dividends as the directors might declare "up to, but not exceeding, four per centum before any dividends shall be set apart or paid upon the common stock." A preferred stockholder claimed the right to participate in the whole of the surplus remaining after payment of the preference or, failing in that, the right to participate in so much of the surplus as remained for dividends after the common stock had received a dividend equivalent (whether as to rate or amount was not stated in the opinion) to that received by the preferred. The court denied both rights upon the ground that, if the words "not exceeding" did not limit the dividend rights of the preferred stock—if these words did not mean that the holders of preferred stock were entitled to four per cent. and to no more in any circumstances—then the words were meaningless.

The plaintiff in this case contended that the whole purpose of the certificate was to declare what the preferred shareholders were entitled to before the common stockholders were entitled to anything. The language of the certificate is ambiguous, to say the least. It might be taken to mean that no more than four per cent. should be paid to the preferred either before or after any dividends should be set apart or paid on the common, or it might mean that no more than four per cent. should be paid to the preferred until that amount had been paid to the common. Under the first construction, the words "not exceeding" would limit the total amount and under the second there would be no such limitation.

If the express terms of the preferred contract with the corporation, as evidenced by the stock certificate, allocate surplus earnings as a fund out of which such dividends as may be declared must be paid on stock other than the preferred, preferred stockholders are not entitled to participate in surplus earnings in addi-

tion to the amount specified in their contract with the corporation. This was the decision in a Virginia case in which the court said:

“Our conclusion, then, is that there is no error in the decree, and that the preferred stockholders . . . are limited to five per cent. dividends in any fiscal year, and can not participate further in the surplus net profits for such year because by their contract they have expressly accorded to all of the other stockholders the paramount and hence exclusive right to have dividends therefrom, subject only to the legal and proper discretion of the board of directors.”

In *Keith v. Carbon Steel Company*, the court held that a holder of non-cumulative six per cent. preferred stock, who had received his preference dividend in full, was not entitled to restrain the corporation from paying accumulated earnings amounting to nearly half its capital exclusively to the common. According to District Judge Orr:

“The holders of preferred stock must be deemed to have been unwilling to take the same risks as the holders of the common were willing to take. In other words, they were not willing to take their certificates without an expression thereon of the amount which they were entitled, respectively, to receive out of the profits. . . . We are unable to see why, in contracts such as these before us, the expression of the amount to be received under the contract should not be deemed to be an exclusion from the minds of the parties of any additional amount. . . . A certificate of stock does not ordinarily express the share of the profits which a stockholder shall receive from the corporation, and therefore the law implies a term in the agreement that the holder of such certificates shall share equally in the profits set apart by the management for the payment of dividends. There can be no implication, however, where the contract expressly states the percentages which one contracting party is to receive from another.”

In two early English decisions are judicial dicta to the effect that profits set apart by directors for depreciation, insurance and improvements go to the ordinary shareholders exclusively, although there are preferred shares entitled to a preferential dividend of five per cent. The court made this statement: “It is generally assumed that where the preference shares are given a fixed preferential dividend at a specified rate that impliedly negatives any right to take any further dividend, and probably this assumption is well founded.”

In *Will v. United Lankat Plantations Company*, the view is taken that a cumulative preference is a limitation of the total



amount. In other words, preferred stockholders are denied the right of participation. According to the facts, the holders of ten per cent. cumulative preferred stock had prior rights over the common as to capital and dividend. The company sold part of its business for cash and 45,000 fully paid shares of the purchasing company. It paid ten per cent. to the preferred stockholders and distributed the shares to the common. A preferred stockholder sued to have the distribution declared illegal on the ground that the preferred should share, *pari passu*, with the common in excess of ten per cent. on both classes. This case is unique as one of first impression in England. According to Cozens-Hardy, master of the rolls:

“It is remarkable that, although preference shares have been known for so many years, . . . and although during all those years preference shares . . . have been well known and dealt with in millions, not an instance has been called to our attention in which the claim now set up has been called to our attention.”

Justice Joyce of the chancery division allowed the contention of the plaintiff, but the court of appeals unanimously reversed the lower court and expressly held that in the absence of any contrary provision in the statute or contract the preferred was entitled to only the stipulated dividend. On appeal, the house of lords unanimously affirmed this decision.

The decision in the *Will* case apparently is based upon the court's interpretation of the contract, and the following statement occurs in *Palmer's Company Precedents*: “It is generally assumed that where the preference shares are given a fixed preferential dividend at a specified rate that impliedly negatives any right to take any further dividend, and probably this assumption is well founded.” Lord Haldane said: “Shares are not issued in the abstract and priorities then attached to them *uno flatu*, and when you turn to the terms on which the shares are issued you expect to find all the rights as regards dividends specified in the terms of the issue, and when you do find these things prescribed it certainly appears to me unnatural to go beyond them, and look to the general provisions of an article which is only to apply if nothing different is said.” Cozens-Hardy, master of the rolls, declared: “One can not be aware to any extent of what goes on in the stock market without knowing that preferential shares of stock are ordinarily spoken of and regarded, and I think properly regarded, as shares of stock which carry a fixed preferential dividend and are

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entitled to nothing more." According to Lord Justice Farwell: ". . . the birth of preference shares limits in its very inception the whole of its attributes. It has a preference, and such a preference as is given to it by the resolution, and no more; and I should have said that ever since I have been at the bar, or have had anything to do with company matters, that has always been perfectly well understood."

In the case of *Collaroy Company, Limited v. Giffard*, the articles provided that "the preference shares shall confer the right to a fixed cumulative preferential dividend. . . ." The court decided that the use of the term "the right" instead of "a right" showed conclusively that it was not intended that the preferred shares should have any right other than the preference.

Canada apparently follows the English rule. In *Ramsay v. Steel Company of Canada, Limited*, Justice Orde said:

"Where the preference shares, duly created and issued, are declared to be entitled to a fixed cumulative preferential dividend at a certain rate per annum, any further participation in the profits of the company is impliedly negatived, and if the right to any further participation is to be granted it must be distinctly so stated."

Cases involving participation rights of preferred shareholders in stock dividends should also be reviewed.

*Niles v. Ludlow Valve Manufacturing Company* is the first decision in point. According to the facts, 4,000 shares of stock were preferred as to eight per cent. dividends and as to capital. In addition, the holders of this stock were entitled to equal voting power with the holders of 3,000 shares of common stock. The statutes of New Jersey, the state of incorporation, provided that the preferred stock should be entitled to a fixed yearly dividend of eight per cent., to be paid before any dividend could be declared on the common stock. Over a period of two decades, in nearly every year, a larger dividend was paid upon the common stock than upon the preferred, but the holders of the latter stock made no protest. The stockholders, common and preferred, authorized the board of directors to distribute from surplus a 100 per cent. dividend of common stock to the holders of the common shares. A holder of preferred, who did not vote for the measure, claimed the right to share in the dividend and sought to enjoin the distribution of it unless the holders of the preferred shares should be allowed to participate. The lower court dismissed the bill. It

interpreted the statutes to mean that the preferred shareholders were entitled to eight per cent. and no more and held that the remainder of the surplus available for dividends belonged to the holders of the common stock alone. In affirming the judgment, the circuit court of appeals, speaking through Judge Coxe, said:

“The common shareholders bear substantially all the losses of adversity and are entitled to the gains of prosperity. A contract that they should assume all the risk with no corresponding advantage should be clearly established. We find nothing in the law or the certificate or in the past action of the defendant (the corporation) to indicate that anyone connected with the business supposed that the preferred stockholders were to share equally with the common stockholders in the division of surplus earnings.”

Circuit Judge Ward gave the following strong dissenting opinion in the Niles case:

“The general principle is that all stockholders share equally in net profits, except as their relations are altered by statute or contract. If the preference is given to one class of stockholders over the rest, it should be construed consistently with this general principle so far as possible. For instance, if the preferred stockholders are given the right to receive a dividend of a fixed amount before the common stockholders get anything, the latter should receive an equal amount, and then the surplus, if any, be equally divided between the preferred and the common stockholders. Where the privilege is intended to be restrictive, the restriction should be expressed, as by saying that the preferred stockholders are to be paid a certain dividend before the common stockholders get anything and are to receive nothing more. In this case the certificate of the company provided that the preferred stockholders should be paid an annual cumulative dividend of eight per cent. before the common stockholders received anything. There were no words of restriction. Therefore I think that they were entitled to receive their proportion of the stock dividend in question. It is true that the dividends had for many years been declared and paid as if the privilege to the preferred stockholders were restrictive, the question never having been raised, but I think this does not prejudice the rights of the preferred stockholder who now for the first time raises the question.”

In *Stone v. United States Envelope Company*, a common stockholder sought to restrain a corporation from distributing equally between the common and preferred shareholders a stock dividend representing earnings employed for improvements, claiming that as the preferred had been paid in full, all remaining profits belonged solely to the common. According to the facts of the case, the United States Envelope Company had outstanding 40,000

shares of seven per cent. cumulative preferred stock and 10,000 shares of common, with equal voting power. All of these shares had been issued except 2,500 shares of common, which the corporation proposed to sell at \$150 a share to the holders of both classes of stock. This price was less than the value of the stock. Stone, a common shareholder, requested an injunction to restrain the company from selling this stock to the preferred, on the ground that such a sale would have the effect of a dividend. The court refused to allow the preferred to share in the purchase of this stock and thus receive a dividend from the surplus profits of the difference between the value of the stock and its selling price, on the ground that the ordinary buyer of preferred shares buys with the understanding that the maximum of his right to share in dividends is fixed by the fact of preference and at the amount of the preference. According to Justice Deasy: "We put the decision, however, upon the ground that, where nothing to the contrary appears, the creation of the preferred stock prima facie implies that the preferential rights of the (preferred) shareholders are given in lieu of and to the exclusion of the equality of participation which would otherwise exist." After discussing the Pennsylvania rule, the court said: "The other theory which we believe to be better and supported by the weight of authority is that in receiving the greater security of his preferential rights, the preferred impliedly agrees to accept such rights in lieu of equal participation." Justice Deasy then continued with these words: "Independent reasoning as well as what we deem to be the preponderance of authority sustains the plaintiff's position. Words in contracts, as well as in statutes, should ordinarily be construed 'according to the common meaning of the language.' Surely the phrase 'preferred stock' holds out to the ear of the ordinary investor no promise of participation in earnings beyond his preferential dividend. That this is true has been recognized by the authorities." Hence, preferred stockholders, against the objection of common stockholders, can not be given a preemptive right the same as common stockholders to purchase common stock from the corporation at a price less than the value, since this in effect would be an additional dividend to the preferred stockholders.

According to the facts of *Tennant v. Epstein*, 356 Ill. 26 (1934), the plaintiff held common stock in an Illinois corporation which had outstanding shares that were preferred as to assets on dis-

solution and as to dividends to the extent of seven per cent. Under the constitution of Illinois each stockholder, common or preferred, is entitled to one vote for each share held. The board of directors voted a dividend of common stock, one share for each common and each preferred share outstanding. This stock was issued and subsequently a cash dividend was paid on all common stock which, of course, included the stock received as a dividend. The plaintiff asked the cancellation of the stock dividend and the repayment of the cash dividend, and the court granted his request. It seemed that the purpose of the stock dividend was to create a right to additional cash dividends in the holders of the preferred stock. Consequently, holders of preferred stock, which is limited by certificate to dividends of a specified percentage, are not entitled to participate in a stock dividend because such dividend is an indirect way of distributing cash surplus.

According to the facts of *Borg v. International Silver Company*, the defendant corporation proposed to issue treasury stock to both preferred and common stockholders at \$50 a share, when the par was \$100 and the book value probably was more, as the company had accumulated a substantial surplus. The court said: "If it is true—and it appears not to be disputed—that the corporation has a substantial surplus to which the preferred stockholders would not be entitled in the event of dissolution, then the action of the directors in making an offer which results in the preferred stockholders' getting a major portion of the proposed issue at fifty per cent. of its par value, would seem to work an injustice to the common stockholder." The injunction was granted. The rule permitting the preferred stockholders to participate was denounced by the court on the ground that it is unfair to the holders of the common stock who should not be forced to assume a much greater risk than the preferred holders with no better chance for gain.

In *Riverside and Dan River Cotton Mills v. Branch*, a surplus was to be distributed in the form of voting shares to the common stockholders. The court decided that the preferred shareholders were entitled to participate in stock dividends beyond the amount of their preference, even though their right to dividends was limited to the preference given. It reasoned that, if the shares were increased and the preferred holders were not allowed to participate, the value of their rights upon dissolution would be decreased. Since the preferred had equal voting power with the common, an

increase in the number of shares would decrease the proportionate strength of the preferred stockholders in the control and management of the corporation if they were not given a proportionate part of the shares distributed. Justice Chichester made the following statement in delivering the opinion of the court:

“ . . . When there are two kinds of stockholders, one preferred and the other common, when there is no difference in their status under the corporate charter except a preference as to dividends, and none under the statute law, the sale of stock to common stockholders at par, without giving the preferred stockholders an opportunity to purchase their proportionate part under the same conditions, or the issuance of a stock dividend to the common stockholders to the exclusion of the preferred stockholders, is an impairment of the rights of the latter which entitles them to relief in equity if the stock has not been delivered, or to damages for breach of a contract obligation if it has.”

The English rule that preferred stockholders are entitled to their contractual dividend and no more where there is no provision to the contrary has been carefully considered and solemnly adopted by several courts in the United States, as well as in England and by at least one court in Canada as the better view. Aside from authority, it is believed that it conforms more nearly to business notions than the other rule. The common stockholders expect to receive the greater share of the corporation's profits. If it were not for this they would be unwilling to assume the risk involved in subscribing to common stock. To permit the holders of preferred stock to share pro rata in the surplus is to give them identical benefits for a smaller consideration because, on account of their stipulated dividend, they bear less risk than the common. It is highly unreasonable that the holders of the common stock should bear all the losses of lean years and that the preferred should enjoy pro rata the surplus earnings of prosperous years. The corporation grants the preference to the preferred stockholders in return for giving up the right to further dividends after the specified dividend has been paid. If participation is intended, it may be provided for by the contract. Absence of such provision should be construed as a denial of the right.

The participation rights of preferred stockholders, in the absence of a provision in the contract, is a question that has come before few of our state supreme courts. Since so few cases on the point have been adjudicated, it is uncertain what view any particular court will take of it, unless one of the precedents is, in the

opinion of the court, precisely in point and binding upon it. Since the English rule is supported by reason and by weight of authority in this country, in England and in Canada, it probably will be given careful consideration when the question arises in states that as yet have no precedents on the point.

## The Paper Industry

BY ERIC A. PULLAN

The uses of paper are now widespread, but in days long gone by it was manufactured solely for use as a vehicle for the transcription of human thoughts and for the record of events. It is this use of paper which gives it historical significance. Paper has given the world of today its knowledge of the world of yesterday; it has allowed people virtually to converse with their ancestors. The mummy in his Egyptian coffin still enlarges our historical knowledge by means of the papyrus buried with him.

It is from the word "papyrus" that "paper" is derived. Papyrus was the Latin name of an Egyptian reed, from the inner bark of which a kind of writing paper was made in ancient Egypt. The name papyrus was in turn applied to the writing material thus made. The material consisted of strips of the stem of the papyrus plant pasted evenly across similar strips in thin layers and dried under pressure. It was made by the Egyptians, the Greeks and the Romans. Papyrus was, therefore, the forerunner of modern paper, although paper, as we speak of it now, is as much in advance of papyrus as papyrus was in advance of brick, stone, lead, copper, brass, leaves, bark, wood and skins, which preceded it. The following definition of paper appears in the *Paper Trade Journal*, August 16, 1923: "A compacted web or felting, commonly in the form of a thin flexible sheet, formed from an aqueous suspension of fibers, usually vegetable in origin, used for writing, printing and for various other purposes. If a web or sheet is made by felting the dry fibers, it is felt or bat and not paper, while if the sheet is spongy and felt-like but is made from a suspension of fibers in water, it is paper and not felt, as these terms apply specifically."

No one has definitely established the exact date when paper-making originated, although certain historians have traced its first appearance to the second century, B. C. China seems to have been the cradle of the paper industry, and the Arabs introduced paper making into Europe in the eighth century A. D. The industry developed first in Spain and, later, to a greater extent in the south of France. Gradually it crept northward to Germany, to Holland, and finally to England, which for many years had imported all of its paper. The first paper mill in the



United States was started on the Wissahickon river near Philadelphia in 1690, by a man, whose anglicized name was William Rittenhouse. According to records this was the only American mill for some time. Later on other paper mills arose in other eastern sections of the continent. A quaint but interesting poem anent this first paper mill of William Rittenhouse appears in Richard Frame's, *A Short Description of Pennsylvania*:

"The German-town, of which I spoke before,  
Which is, at least, in length one mile and more,  
Where lives High German People, and Low Dutch,  
Whose trade in weaving linnin cloth is much,  
There grows the flax, as also you may know,  
That from the same they do divide the tow;  
Their trade fits well within their habitation,  
We find conveniences for their occupation,  
One trade brings in employment for another,  
So that we may suppose each trade a brother;  
From linnin rags good paper doth derive,  
The first trade keeps the second trade alive;  
Without the first the second cannot be,  
Therefore, since these two can so well agree,  
Convenience doth approve to place them nigh,  
One in the German-town, 'tother hard by.

"A paper mill near German-town doth stand,  
So that the flax, which first springs from the land,  
First flax, then yarn, and then they must begin,  
To weave the same, which they took pains to spin,  
Also when on our backs it is well worn,  
Some of the same remains, ragged and torn;  
Then of those rags our paper it is made,  
Which in process of time doth waste and fade;  
So what comes from the Earth, appeareth plain,  
The same in time returns to Earth again."

At this time the machinery used was of the simplest kind—a mortar and pestle to grind the rags to pulp, a small container for the paper "stuff," a mould and a device for squeezing water from the sheets. Inventions of new machinery were not rapid, and it was not until the latter part of the eighteenth century that the forerunner of the modern beater was invented in Holland. Not only was the machinery of crude design in these early stages, but the materials used were of the simplest, mainly consisting of cotton and linen rags. It was after the invention of machinery which could produce in large quantities and after the discovery of additional raw materials which could enter into the making of

paper, that the industry began to flourish and to assume larger proportions. It was in 1798 that a Frenchman by the name of Robert gave out to the world that he "had discovered a way to make, with one man, and without fire, by means of machines, sheets of paper of a very large size, even twelve feet wide and fifty feet long." The French government realized how important was the invention and gave Robert eight thousand francs, a patent for fifteen years and granted him permission to go to England with his model for the purpose of obtaining English capital. The machine had been tried in a French mill and the owner of this mill, becoming interested, bought the patent and proceeded to England where he secured the services of an English mechanic to construct a machine. Lack of capital necessitated the calling in of two rich London stationers, the Fourdrinier brothers, who, with Donkin (the mechanic), worked on the machine until they became bankrupt. However, the English government came to their assistance and voted them seven thousand pounds to help them out of their financial troubles. The machine, therefore, which revolutionized the paper industry was named after the Fourdrinier brothers, but no less credit is due to Robert, the original inventor, and to Donkin, the mechanic. In addition to these pioneers there were others: John Dickinson, inventor of the "cylinder" type of machine; T. B. Crompton, inventor of driers; M. Causon, inventor of suction boxes; John Wilks, inventor of the dandy roll, and so on, each inventor contributing something necessary to the perfection of machines which today turn out millions of tons of paper a year in the United States alone. With the new machinery producing paper so much more rapidly than the old methods, people began to look for new sources of supply of raw material. In 1719, Reamur noticed how wasps made their nests from wood and told paper makers of his discovery, but it was not until over one hundred years later, in 1840, that ground wood pulp was produced. To sum up, then, we have Robert's invention in 1798 and the invention of wood pulp in 1840, a space of about forty years wherein the paper industry advanced at a tremendous pace, after dragging along for about eighteen hundred years.

The following description of the making of paper is, of course, a general statement and does not cover the various technicalities of manufacture. It presents merely the underlying principle of what might be termed the formation of paper.

Small cellulose fibers derived from various raw materials (which will be discussed later) are held in suspension in water. The water containing these fibers is carried over a wire cloth, which allows the bulk of the water to pass through, leaving a deposit of the pulpy mass of fibers. Evaporation and expulsion of more water from this pulpy mass produces a sheet of paper. As already explained, the original raw materials from which the fibers were derived consisted principally, almost entirely one might say, of rags. At the time when the machine age came into its own and replaced the handicraft or small-tool age most industries grew rapidly, but the paper industry did not. It was still handicapped by the lack of raw materials, from which the essential fibers could be obtained. Rags were exceedingly scarce. Many and diverse were the methods used to acquire rags. Advertisements appeared in the papers; premiums were offered; suggestions were made to keep "rag-bags," and even the bards were called on to make appeals for rags. For instance the following poetic appeal appearing on an advertisement is quoted in *The Black River Gazette* of November 9, 1907, in an article entitled "A history of Lewis County in the State of New York" by Franklin B. Hough.

"Sweet ladies, pray be not offended,  
Nor mind the jest of sneering wags;  
No harm, believe us, is intended,  
When humbly we request your rags.

"The scraps, which you reject, unfit  
To clothe the tenant of a hovel,  
May shine in sentiment and wit,  
And help to make a charming novel.

"The cap exalted thoughts will raise,  
The ruffle in description flourish;  
Whilst on the glowing work we gaze,  
The thought will love, excite and nourish.

"Each beau in study will engage,  
His fancy doubtless will be warmer,  
When writing on the milk-white page,  
Which once, perhaps, adorn'd his charmer.

"Though foreigners may sneer and vapor,  
We no longer forc'd their books to buy,  
Our gentle belles will furnish paper,  
Our sighing beau will wit supply."

For many years the lack of raw materials hindered and even endangered the paper industry, and the demand for paper outgrew the supply of rags. The old colonists were frugal people and they wore their clothes for a long time. No doubt the modesty of the ladies prevented them from selling certain of their old clothes to the paper mills, even though good money or other barter was offered. It was not until certain events occurred that the urgency of the appeals for rags diminished:

- (1) Invention of ground wood in 1840.
- (2) Work on esparto grass and wood by soda process in 1854.
- (3) Invention of the sulphite process in 1866.

From this point, the supply of raw materials was sufficient to meet demand for the finished products and the industry advanced by leaps.

In spite of the fact that by far the largest percentage of fibers used comes from wood, this does not mean that the demand for rags has diminished. And there may come a time again, although this seems to be a long way off, when it will be necessary to find a substitute for wood pulp to supply the fibers to make paper, as it was necessary to find a substitute for rags. Paper is now being used for innumerable purposes. The demand increases, and the unavoidable law of supply and demand again comes to the fore. The supply is not increasing in proportion.

There seems to be a division of opinion among paper experts as to the adequacy of the future supply of wood pulps. For many years to come, however, there should be no need to worry. In the history of paper making in the United States, there has never been a year when the number of cords of wood used for paper manufacture has exceeded seven and one-half million. On the other hand, the United States lost a large portion of its newsprint production in the last two decades. The greatest amount is now imported from Canada.

There seems to be no question, however, that a more far-reaching policy of reforestation, similar to that adopted in Canada, France, Germany and other countries is necessary.

#### MANUFACTURE

In the manufacture of paper there are five general processes, viz.:

- (1) Separation of fibers from raw material.
- (2) Formation of pulp from fibers.

- (3) Beating and refining of fiber and intermingling it with other constituents.
- (4) Formation of paper from the "stuff."
- (5) Finishing and preparation for sale.

There are two distinct classes of wood pulps, mechanical and chemical. Mechanical wood pulp or ground wood is used principally in the manufacture of newsprint; it is also used in making cheap cardboards, pie plates, etc. The cost of manufacture is low compared with that of other papers and the paper produced has no permanent qualities. In order to strengthen it, sulphite pulp is used. Most people know that newspapers are made from wood pulp and are inclined to think that all paper made from wood must be of a flimsy nature. The idea is erroneous, as wood cellulose chemically treated can produce some very fine grades of paper.

The principal chemicals used in making chemical wood pulp are caustic soda, sulphide of soda, sulphate of soda and bisulphite of lime. Caustic soda is used in the preparation of soda pulp. Caustic soda, sulphide of soda and sulphate of soda are used in the preparation of sulphate pulp. Bisulphite of lime serves in the preparation of sulphite pulp. Mitscherlich pulp is produced by a special method of making sulphite pulp. In the soda-pulp process the wood used consists mainly of poplar, gum, chestnut, etc. To make sulphate pulp, spruce wood is largely used, although this pulp can be made from various woods. Spruce wood with the wood of other conifers also enters considerably into the making of sulphite pulp.

The paper manufactured from the different pulps may be generally classified as follows:

From soda pulp:

Blotting

Book

Cover

From sulphate pulp:

Kraft (brown wrapping paper)

Kraft bag paper (paper bags)

Kraft board (known also as jute board)

Kraft waterleaf (used mainly for towelling)

Sulphate wrapping (brown wrapping paper)

From sulphite pulp:

Sulphite bond (paper of bond type)

Sulphite manila (wrapping paper colored like manila)

Sulphite board (pulp board)

Sulphite bag paper

This classification does not include all the kinds of paper made from the various pulps, but it serves as a general index. The term "sulphate pulp" is now used loosely to define an admixture of sulphate pulp and other chemical pulps. In fact, few papers are made from one kind of material only—most of them contain various fibers with the addition of non-fibrous constituents. Of the chemical wood pulps, sulphate pulp supplies the largest and most varied supply of papers.

The next raw material is waste paper, the second largest supplier of fibers. It consists of old newspapers, magazines, books, paper shavings, binders' waste and a heterogeneous mass of anything that has ever seen the inside of a paper mill. This material must first be graded. The lowest grade, which contains miscellaneous papers of all kinds and colors, is used only in the production of coarse papers. By graduation of colored papers, papers made of ground wood, etc., are eliminated until the highest grade, consisting of old writing and ledger papers, is reached. Sorting of the waste paper removes foreign material; boiling in a solution of soda ash removes ink; and from this point the stock is washed and bleached in much the same manner as rags. Some of the processes which I have described are employed only in the manufacture of fine papers. In the manufacture of coarse papers and boards, the waste paper, after being dusted and sorted, is merely hydrated before going into the beaters.

Rags should be of cotton or linen and should be generally free of silk threads, oil, grease, leather, rubber, etc. The first process is similar to that for waste paper, but it is more thorough. The rags are cut, dusted, sorted, seams are opened up, buttons, hooks and eyes are removed. Then the rags are ready for boiling, or "cooking." This removes dyes and grease. After the boiling comes washing and then bleaching.

Esparto grass, which is not used to a great extent in this country, but is one of the principal raw materials entering into paper making in England and other European countries, is made into pulp by the soda process.

After the stock has been worked up by one or other method, depending on the nature of the raw material, the next step is to mingle the non-fibrous components with the stock. These consist

mainly of mineral fillers, sizing materials and coloring matters. The fillers add smoothness to the paper. The most common filler is China clay. Others are certain silicates of magnesia and a preparation of barium sulphate. Sizing materials give resisting qualities to paper against ink or water; they consist of glutinous or viscid substances such as starch, gelatine, resin, glue, etc. The coloring matters consist of various dyes, the purpose of which is obvious.

Mixing of the filling, sizing and coloring matters with the stock is done usually at the same time as the "beating." Beating consists in comminuting the fibers, and of such importance is the treatment accorded the "stuff" in the beaters, that it has been truly said "the paper is made in the beaters." Quick beating with keen knives results in absorbent paper. Slow beating with blunt knives gives paper of the opposite kind. This illustrates how important a place the beating machine takes in determining the quality of the paper finally produced. It is the usual custom in a paper mill for the man in charge of the beaters to be given a formula directing him how to mix the raw materials in his machine, and these are placed in the machine as directed, with a lot of water. After the "stuff" has passed through the beaters it goes to the "Jordan" where it is further refined. It passes through at least one of these machines and then passes over a "sand settler." After traversing the sand settler it reaches a screen or series of screens, the object of which is to make the stock uniform and to exclude foreign substances. After leaving the unwanted stock on the screens the "stuff" which has passed through is ready for the paper machine. (The screens previously mentioned are usually considered as part of the wet end of the paper machine itself.) There are three general processes in a paper machine:

- (1) Forming and pressing
- (2) Drying
- (3) Cutting and binding

The paper machine, then, might be said to have three distinct parts: the wet end, the middle and the dry end. There are two distinct kinds of paper machines, Fourdrinier and cylinder. The difference between the two lies in the "wet end" of the machine. However, the function of the wet end of both machines is the same, namely, to bind the fibers in the pulp together. This is accomplished by passing the stock, which at this point contains

almost 99 per cent. water, over wire meshed screens or cylinders. Pressure is exerted by means of squeeze rolls, and the paper is carried through between endless felts.

The drying is done in the "middle" of the machine, and the various cutting knives, calender stocks, binding rolls, etc., are in the "dry end."

Other machines are used for making specific kinds of paper, such as gummed papers, high finished papers, etc.

#### FINISHED PRODUCT

The principal tests of finished paper are for weight per unit, thickness, bursting strength, tensile strength, folding strength, expansion, absorption, chemical constituents, nature and kinds of fibers, color, opacity, etc. Although the processes of paper manufacturing appear to be simple, great care is essential in order to turn out a finished product of the highest standard. Defects arise which have to be remedied. Sometimes the paper is not uniform—this may be caused by lack of control of the "stock" as it passes through the machine or, by tracing the cause further back it may be attributed to negligence on the part of the man controlling the beaters. Again the finish may be defective, usually caused by non-uniformity of dampness in passing through the calenders. Holes in the paper, dirt, etc., are generally attributable to careless handling of rags and old paper stock and to accumulation of dirt or grease on the machines themselves. Defects in coloring, coating, packing, etc., appear at various times.

#### MARKETING

The two principal methods of disposing of paper are through jobbers and direct sales to the consumer. The jobber usually handles the majority of writing and wrapping paper and, to a less extent, book paper. Of course, other papers are also sold in this manner. Newsprint is almost always sold direct to the consumer. It may be said, as a general statement, that the large consumers buy direct; others buy through jobbers. There is a considerable amount of re-manufacture to be done by some consumers, such as manufacturers of stationery, tags, books, boxes, toilet accessories, etc.

Paper manufacturers and also paper jobbers have formed associations for the purpose of gathering statistics relative to production, consumption, etc., for the purpose of producing uniformity



in trade customs, and for sundry other purposes, both technical and educational.

### ACCOUNTING

It seems to be agreed among progressive manufacturers, whether they manufacture paper or some other product, that they must have some accounting system, which indicates to them the cost of their product. In the process of compiling costs other data are accumulated and statistics are obtained. The benefits of a cost system are, therefore, not entirely confined to the resulting ability to determine a product's cost.

In obtaining costs of a product one is serving at least two main purposes. The first is to use the information in the general accounting of the industry; the second is to provide a medium for calculating selling prices. An ideal cost system is one which is controlled in the general ledger, or in a subsidiary ledger, and is in turn controlled through the general accounting system. Many kinds of paper are manufactured under different conditions. It is obvious therefore that no fixed system will be suitable for all mills; nevertheless a certain approach to uniformity can be obtained.

The following list shows generally the derivation of the mill cost of a paper product:

Rough paper cost:	Finishing:
Material cost:	Rewinding
Purchased raw material	Cutting
Handling and storage	Calendering
Prepared materials:	Plating
Half stuffs:	Sorting
Material	Etc.
Handling and storage	Packing and shipping:
Preparation	Wrapping
Sizing—material, labor and burden	Crates, etc.
Conversion cost:	Labor and burden
Converting labor and burden:	
Beaters	
Chests	
Jordans	
Paper machine	
General mill burden:	
Administrative expense	
Research expense	

In costs in a paper mill there is one important feature which must be observed closely—that is the change in weight of material

## *The Paper Industry*

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as it passes from one department to another. At one time it was customary to estimate the shrinkage; but more satisfactory results can be obtained by keeping records of the number of containers obtained from a given quantity of raw material and establishing a value rate per container.

Another factor to be remembered in costing is that the expenses for repairs in a paper mill usually run fairly high, and are not consistent enough to indicate accurate monthly costs. To obviate this one may include, as a fixed monthly charge, an average allowance for repairs, and the offsetting credit may be to an account "reserve for repairs." The actual cost of repairs can then be debited to the reserve account.

It is comparatively easy to make a physical inventory of the stock in a paper mill, and it is advisable to do so at the end of each month, or at any rate at the end of three months, so as to keep a close check on the perpetual-inventory records.

There is little to be said of the general accounting records of a paper mill which can not be said of any other manufacturing concern. A list of suggested balance-sheet accounts follows:

<i>Assets</i>	<i>Liabilities and net worth</i>
Current assets:	Current liabilities:
Cash	Notes payable
Notes receivable	Accounts payable
Accounts receivable	Accrued liabilities (various)
Reserve for bad debts (valuation account)	Reserve for income taxes
Inventories:	Bonded indebtedness
Raw material	Capital and surplus:
Prepared material	Preferred stock
Finishing material	Common stock
Maintenance material	Surplus
Supplies	
Work in process	
Finish product	
Prepaid expenses (various)	
Property, plant and equipment:	
Land	
Buildings	
Manufacturing equipment	
Steam equipment	
Maintenance equipment	
Office furniture and fixtures	
Reserve for depreciation (valuation account)	
Deferred charges	

# Students' Department

H. P. BAUMANN, *Editor*

## AMERICAN INSTITUTE EXAMINATIONS

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

### EXAMINATION IN AUDITING

November 15, 1934, 9 A. M. to 12:30 P. M.

*The candidate must answer all the following questions:*

No. 1 (5 points):

- (a) State how a straight voucher system is used, recorded and controlled.
- (b) May it be used in conjunction with an accounts-payable ledger, and in what way?
- (c) Under what conditions is it preferable in conjunction with an accounts-payable ledger?

*Answer:*

(a) A "straight" voucher system requires the preparation of a voucher for every disbursement. These vouchers, when properly approved, are entered in the register in numerical order, recording the date, payee, terms, the amount (under the column heading "Vouchers payable"), and the distribution to the cost, expense, asset, or other accounts. The total of the vouchers-payable column is posted, at the end of the month, to the credit of the vouchers-payable account in the general ledger. The accounts to which the expenditures are chargeable are debited.

The cheque register should contain columns showing the number of the cheque, the number of the voucher, the amount to be charged to vouchers payable (the total of the amount of the cheque, plus discounts earned, allowances, etc.), amount of discounts earned, allowances, etc. The total of the vouchers-payable column in the cheque register should be posted to the debit side of the vouchers-payable account in the general ledger at the end of the month.

When cheques are drawn, the voucher number should be entered in the cheque register, on the line with the recorded disbursement; and the cheque number and date paid should be entered in the voucher register on the line of the corresponding voucher.

After the totals of the voucher-payable columns in the voucher register, cheque record, journal, etc., have been posted, the balance in the general-ledger account should agree with the total of the unpaid vouchers as shown in the voucher register.

(b) The voucher system may be used with an accounts-payable ledger, by opening ledger accounts with each creditor and recording each voucher in the creditor's account.

(c) The accounts-payable ledger is desirable when there are many partial payments, returns, allowances, and adjustments, which may produce complications and frequent errors if ledger accounts are not maintained.

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No. 2 (10 points):

In the annual audit of the firm of John Doe & Co. you find it has sold a substantial part of its accounts receivable to the X Discount Co., receiving an advance of 60% of their face value, the balance to be received when and as the accounts are collected from customers.

The advance was credited to the account of The X Co. when received, but in closing its books for the year the firm has deducted it from the total accounts-receivable balance on the theory that the accounts sold no longer belong to the firm and that the 40% equity in them is due from the purchaser.

You are requested to certify the resulting balance-sheet in this form without mentioning the sale of the accounts, if possible.

- (a) Analyze the above transaction, and
- (b) State three methods from which you could choose in order to give a certificate, qualified or unqualified.
- (c) Which method would you adopt? Give your reasons.

*Answer:*

While the question states that the firm of John Doe & Co. "sold" a part of its accounts receivable it is probable that the firm has guaranteed the collection. It would be misleading to show the unassigned accounts and the equity in the assigned accounts under the one heading, "Accounts receivable." The assignment must be disclosed.

Assume the following:

Accounts receivable:		
Unassigned.....	\$50,000	
Assigned.....	20,000	
Advanced by discount company.....	14,000	

Three methods in which the above may be shown in the balance-sheet of the firm of John Doe & Co. follow:

(1)

Current assets:		
Accounts receivable.....	\$50,000	
Equity in assigned accounts.....	<u>6,000</u>	\$56,000

A footnote should be appended to the balance-sheet stating that the firm was contingently liable in the amount of \$14,000 as guarantor of the assigned accounts receivable.

(2)

Current assets:		
Accounts receivable.....	\$50,000	
Equity in \$20,000 of accounts receivable assigned under guarantee.....	<u>6,000</u>	\$56,000

No footnote is necessary.

(3)

Current assets:		
Accounts receivable:		
Unassigned.....	\$50,000	
Assigned.....	\$20,000	
Less: advance thereon.....	<u>14,000</u>	<u>6,000</u>
		\$56,000

No footnote is necessary.

The first method is the most desirable because it is simple and it clearly shows the facts.

No. 3 (5 points):

You are employed by the firm of Smith & Jones to close its books and prepare a balance-sheet, profit-and-loss statement, and federal income-tax returns for the firm and for each partner. You are not to audit the books. Neither partner keeps private books but each gives you memoranda of his "other" income and allowable deductions and credits.

With the usual income-tax forms you find additional ones which prescribe:

- (1) That the taxpayers must state the fact if they employed anyone, and if so whom, to prepare or advise in the preparation of the return, and to what extent such assistance or advice was received: and
- (2) That the person giving such service must make affidavit as follows:

"I, acting as (advisor or attorney) for the hereto subscribed taxpayer affirm that I prepared the return, that the information set out in the return and accompanying schedules, if any, correctly and truly represents the information furnished or discovered by me during the course of preparation of the return, and that such information is true to the best of my knowledge and belief."

- (a) How would you word the taxpayers' statements on these forms in the above cases?
- (b) As a certified public accountant with all the responsibilities the title implies, what would you do to protect yourself in respect to the affidavit? Give your reasons.

Answer:

- (a) The taxpayer's statements should be worded somewhat as follows:

1. On the partnership return:

"Return prepared by John Doe from books, without audit."

2. On the individual return:

"Return prepared by John Doe from unaudited data which I furnished."

(b) The affidavit is so worded that it affords all the protection necessary in most instances, in the words "The information set out in this return . . . correctly represents the information *furnished or discovered* by me, and . . . is true to the *best of my knowledge and belief*." (The italics are the editor's.) The insertion of the word "to" after "furnished" would clearly state the facts that the return was prepared from information furnished to the accountant, and that what information he possessed he believed to be correct.

No. 4 (15 points):

In the course of your audit of the X Machine Corporation for the year 1933 you discover that the plant account has been written down one-half its book value by the journal entry—

"Dec. 31, 1933. Reserve for depreciation. . . . \$ . . . . .  
To plant account . . . . . \$ . . . . ."

You learn that this was authorized by the board of directors, and you are shown a draft of the proposed report to stockholders in which it is recited that the amount represents the net book value, as of January 1, 1933, of plant and equipment which was idle during the entire year; that its purpose is to show the investment in plant at a conservative figure in accord with general conditions due to the depression; that its effect is to confine the annual depreciation charge to plant actually engaged in production during the year; and that the profit-and-loss statement thus shows the true profit made on actual production and sales. It is further intimated in somewhat guarded language that when and as business improves and the idle plant resumes normal production, the value now charged off will be restored to plant account.

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State whether or not you will approve this procedure by certifying the corporation's statements, and give your reasons in full.

*Answer:*

The directors of the X Machine Corporation appear to have arbitrarily reversed one-half of the plant account against the depreciation reserve for the sole purpose of making a better showing by reducing the annual depreciation charge. The statement in the annual report that the purpose was "to show the investment at a conservative figure" appears to be intentionally misleading, since the net value of the fixed assets has not been reduced, but has been actually increased because of the reduction in the amount provided for depreciation for the year.

This seeming deceit throws some doubt on the sincerity of the directors' justification of their action. However, assuming that one-half of the plant (at cost) actually was idle during the year, the situation might properly have been reflected in the accounts in either of two ways:

1. Remove the cost and the accrued depreciation of the "idle" plants as of January 1, 1933, from the accounts by a charge to surplus; or
2. Record depreciation on the "idle" plant for the year 1933 at normal rates by a charge to surplus, or by a charge to profit and loss as a non-operating item; and, if it appears likely that the plant will be idle for some time, set out the net book value in the balance-sheet under the caption "Idle plant."

If either of these methods had been followed, I would certify the company's statements without qualification.

The company's procedure is open to at least three objections:

1. The depreciation for the year is understated.
2. The property accounts are misstated.
3. The wording of the annual report, when coupled with the entry made, appears to be intentionally misleading.

No. 5 (5 points):

How should the executor of an estate charge the following items as between corpus and income?

- |  |  |
|--|--|
| 1. Physician's fees for last illness.                  | 8. Executor's commissions.                                     |
| 2. Funeral expenses.                                   | 9. Repairs to office buildings.                                |
| 3. Expenses of probating will.                         | 10. Estate and inheritance taxes.                              |
| 4. General expenses of executor.                       | 11. Fire-insurance premium.                                    |
| 5. Loss on sale of investment.                         | 12. Special assessments adding permanent value to real estate. |
| 6. Legal fees for collection of rents.                 | 13. Monthly allowances to beneficiaries.                       |
| 7. Legal fees for defending claims against the estate. | 14. Expenses incident to a change in executor.                 |

*Answer:*

Chargeable to corpus:

1. Physician's fees for last illness.
2. Funeral expenses.
3. Expenses of probating will.
5. Loss on sale of investment (considered as an asset left by the decedent).
7. Legal fees for defending claims against the estate.

10. Estate and inheritance taxes.
  12. Special assessments adding permanent value to real estate.
  14. Expenses incident to a change in executor.
- Chargeable to income:
4. General expenses of executor.
  6. Legal expenses for collection of rents.
  8. Executor's commissions.
  9. Repairs to office buildings (considered as ordinary expense).
  11. Fire insurance premium.
  13. Monthly allowances to beneficiaries (considered as income to beneficiaries).

No. 6 (20 points):

Give the program you would follow in making a balance-sheet audit of a small trading corporation.

*Answer:*

Let us assume that the balance-sheet of the small trading corporation contains the following items:

*Assets:*

Cash on hand  
Cash in bank  
Accounts receivable  
Notes receivable  
Reserve for bad debts  
Inventory  
Prepaid insurance  
Furniture and fixtures

*Liabilities:*

Vouchers payable  
Notes payable  
Bank loans

*Net worth:*

Capital stock  
Surplus

The program would be somewhat as follows:

The auditor should satisfy himself that the system of internal check is adequate. The footings of all columns in all books of original entry should be verified for at least one month, and the postings for the month chosen should be checked. Balances of all general ledger accounts should be verified by footing the year's posting in each account.

*Cash on hand.* The count should be made at the balance-sheet date, if possible. If not, a count should be made during the course of the audit and an examination should be made of the recorded transactions between the balance-sheet date and the date of the count. Any undeposited receipts should be traced into the bank.

*Cash in bank.* The bank account should be reconciled as of the balance-sheet date and as of the date of the cash and securities count (if any); confirmations as of both dates should be obtained from the depository direct. At least one month's cash transactions should be checked thoroughly. Bank

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statements and cancelled cheques as of the date of the cash and securities count (if subsequent to the balance-sheet date) should be obtained from the bank direct; items in transit and cheques outstanding at the balance-sheet date should be traced into the bank. The cancelled cheques, for at least a month, should be examined as to dates, signatures, payees, and amounts, and checked against the cash disbursements record. The endorsements and the bank's perforation indicating payment should be examined. The daily record of deposits should be compared with daily record of deposits as shown by the bank on its statement.

*Accounts receivable.* If possible, the customers' statements as of the balance-sheet date should be checked against their accounts and mailed by the auditor with the request that the accounts be confirmed to him directly. The envelopes in which the statements are mailed should bear an address which will return any undelivered letters directly to the auditor. A list of the customers' accounts should be prepared showing the name, amount owing, and the aging of the accounts; subsequent collections, allowances for discounts, etc., and returns should be entered thereon. The doubtful accounts should be noted and discussed with the credit department, for the purpose of determining the adequacy of the reserve for bad debts. Credit balances, accounts with officers and employees, advances to suppliers, and all accounts other than those arising from sales transactions with customers should be set out separately in the balance-sheet.

*Notes receivable.* At the time of the count of the cash, the notes receivable (and any other negotiable securities) should be examined; those out for collection, discount, or collateral should be confirmed directly to the auditor. If there is no reasonable objection, a confirmation should be requested of the maker. All of the notes should be scheduled showing the name of the maker, the date, the date of maturity, the amount of the note, the rate of interest, endorsements, etc. Any notes collected prior to the examination should be verified by tracing the cash collected into the cash records and thence into the bank. The interest-earned account should also be examined to learn if the interest on the notes has been recorded, or if there has been any interest credited in the accounts on notes which were not recorded as such. Consideration must be given to the adequacy of the bad debt reserve applicable to the notes.

*Inventory.* The extent of the auditor's verification should be set forth in the report, or certificate. As to quantities, it may be by actual supervision, by tests at the date of the audit, or only by examination of the books, records, and inventory sheets. He should investigate as to the method and time of the taking of the inventories, and as to the competency of the persons who took or supervised the taking of them. A comparison of the quantities with previous purchases and sales or with book inventories should be made. The auditor should ascertain that goods held as consignee or as bailee, or goods sold but undelivered, are not included in the inventories, and that any merchandise held by others but owned by the client is included. Merchandise in transit and merchandise for the succeeding season received under post-dated invoices should be included. An examination should be made of the receiving records just prior and subsequent to the balance-sheet date. A certificate should be obtained from responsible officers and employees as to ownership, and as to the



correctness of the quantities, costing, and the indication of spoiled, damaged, or otherwise unsalable or unusable materials or merchandise. The pricing may be verified by examination of purchase invoices, market quotations, and sales made immediately after the balance-sheet date. Freight, drayage, duty, handling costs, etc., may be included as a part of the price. A comparison with the prices of previous inventories should be made. The mathematical accuracy of the inventory may be complete or by tests. If copies of the inventories have been submitted to the auditor he should check these copies against the original inventory sheets.

*Prepaid insurance.* The insurance policies should be examined and scheduled, showing the name of the insurer, the policy number, the kind of insurance, the amount of coverage, the premium, and date of issuance and the date of expiration. The unexpired portion of the premium should be computed and set up as a prepaid expense. The beneficiary under the policies should be noted to ascertain whether an assignment has been made to protect a mortgagee.

*Furniture and fixtures.* If this is an annual audit, only the changes in this account (and its related reserve) during the year should be verified. The correctness of the provision for depreciation should be determined.

*Vouchers payable.* A list of the unpaid vouchers should be prepared from the voucher register and the total checked against the controlling account in the general ledger. The receiving records prior to the balance-sheet date should be checked against the recorded vouchers and vouchers subsequent to the balance-sheet date should be examined, to ascertain that the liability had been taken up for all goods received. If direct confirmation from the suppliers is impracticable, the auditor should request that the creditors' statements be held available for him to check against the records. The liability for any merchandise in transit should be taken up, and also included in the inventory; purchase commitments and the corporate minute book should be examined to learn of any unrecorded liabilities or possible losses.

Accrued liabilities, such as accrued wages, salaries, commissions, taxes, interest, etc., can be verified by examining subsequent payments. Expenses applying to one month, but payable in the following month, such as telephone, telegraph, light, power, etc., must be recorded as an expense for the month which received the benefit. Particular attention should be given to the reserve for taxes. A comparison of the accrued liabilities with those set up at the end of the previous period, as to kind and amount, should be made. In addition, a certificate should be obtained from the treasurer, and the book-keeper, stating that all liabilities for the period or for any previous period have been recorded in the accounts, and setting forth any contingent liabilities of the corporation which have not been entered.

*Notes payable.* A request should be mailed to all creditors to whom notes were issued during the year to send directly to the auditor a list of any notes (giving the date, maturity, interest rate, names of makers and endorsers, and the amount) held by them at the balance-sheet date. Any notes paid between the balance-sheet date and the date of the examination, and the cheque issued therefor, should be examined. The interest-paid account should be inspected to ascertain whether any interest had been paid on notes which were not a matter of record.

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*Bank loans.* A request should be made of the bank to confirm the dates, maturities, security, if any, the endorsements, the amount of the note, and the accrued or prepaid interest thereon as of the balance-sheet date.

*Capital stock.* The stock certificate book should be examined, and a listing made of all of the certificates shown as outstanding. All certificates must be accounted for.

*Surplus.* All entries to surplus account during the year should be traced, and the propriety and the authority for extraordinary entries established.

In addition to the above, the nominal accounts should be scanned, or reviewed.

No. 7 (10 points):

Brown, Smith & Jones, a firm, decide to dissolve partnership and to liquidate the business. Lacking confidence in each other, the partners employ you to conduct the liquidation and to determine the correct amounts due from or to each partner.

Describe in detail the steps you will take.

*Answer:*

It is important that all of the liabilities of the firm be ascertained and recorded on the books. As cash is received from the sale of the assets, the liabilities should be liquidated in the order of priority. Unsecured liabilities should not be paid until sufficient cash has been accumulated to pay them all; or, if it is apparent that the amount of cash to be realized will be sufficient, payments may be made prorata to these creditors.

At the time of the disposal of an asset, the loss thereon should be charged to the partners' capital accounts in the profit-and-loss sharing ratio. It would be well to have the partners agree that no payments are to be made to them until all of the assets have been converted into cash, and the outside creditors have been paid in full. If they insist upon payments before all assets have been realized, provision should be made for possible losses by considering that no further cash will be obtained from the sale of the remaining assets. After providing for the actual, and the possible losses (all in the profit-and-loss sharing ratio), payments may be made to the partners first, against loans, and second, against capital accounts; provided that no payments shall be made against partners' loans, if such loans, or portions of them, must be transferred to the respective capital accounts to make good present or prospective deficits therein.

No. 8 (10 points):

You are making an audit of the X Corporation, among whose assets you find stocks and bonds of the Y Company of a substantial amount. In support of their value you are offered a balance-sheet of the Y Company certified by a fellow member of the American Institute. After careful study of this balance-sheet you are convinced there are serious errors in it and you can not conscientiously accept it. You explain the matter and point out the doubtful items to the officers of the X Corporation, whereupon, after securing the consent of the Y Company, they instruct you to make an audit of the Y Company also.

Bearing in mind the provision in the Institute's rules of professional conduct—that no member shall encroach upon the business of another member—what will you do? Give your reasons. Also state your understanding of the meaning of this provision of the rules.

*Answer:*

I would get in touch with the fellow member who certified the balance-sheet of Y Company, and explain the circumstances to him. He would be given an opportunity to explain that there were no serious errors in the balance-sheet. If, after my conference with him I still felt that his work could not be accepted, I would proceed with my audit of the accounts of Y Company.

The rule involved is number 8 of the rules of professional conduct of the American Institute of Accountants which reads: "No member or associate shall directly or indirectly solicit the clients or encroach upon the business of another member or associate, but it is the right of any member or associate to give proper service and advice to those asking such service or advice."

No. 9 (10 points):

You are engaged in auditing the accounts of the American Manufacturing Company, a small corporation, the president owning approximately 96% of the outstanding capital stock. The company had been exceedingly profitable for a number of years and had invested some of its profits in good marketable securities so that funds would be available for an addition to its plant. Examining the securities you find in place of \$25,000 par value of bonds, carried on the books at \$20,000, a demand note for \$20,000 signed by the president. The minutes of the board of directors show that these securities were lent to the president for his use as collateral to secure some personal transactions which have no relation to the affairs of the corporation. The securities are held by the Manufacturers' National Bank as collateral for the president's personal note, and you have received the bank's confirmation.

How will you show this condition in the balance-sheet and how will you qualify your certificate?

*Answer:*

The question which the auditor should put to himself is—were the bonds loaned, or sold to the president of the company?

The minutes of the board of directors indicate that the bonds were loaned to the president, and remained the property of the company, even though the company did not have possession or control of the securities at the date of the balance-sheet. Hence, the account should be shown as securities, and not as a note receivable, in somewhat the following manner:

Securities loaned to officer (see footnote)                      \$20,000

As a footnote, I would show "securities of a value of \$20,000 were loaned to Mr. X, the president of the company, who has given the company his demand note for \$20,000 as collateral. These securities were pledged by him as collateral for his personal note to the Manufacturers' National Bank."

If the transaction were shown as discussed above, it would not be necessary to qualify the certificate.

No. 10 (10 points):

You are to audit the accounts of the Kaslek Manufacturing Company at December 31, 1933, and your certified balance-sheet is to be used for credit purposes. On December 28, 1933, the corporation sold a piece of idle property, the terms of sale being one third cash, one third in a note due in 30 days and one third in a note due in 60 days. The price was determined by outside appraisal of October 15, 1933, and your investigation revealed that the transaction was apparently regular in every way. There were the proper resolutions in the minutes and all the necessary documents were produced for inspection. You also find that the cash had been duly deposited. You discover, however, that

*Students' Department*

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the purchasing company is controlled by a stockholder of your client, and you suspect that the transaction took place for the purpose of window dressing. On the date of your examination the first note is unpaid and the second note is not yet due. It more than doubled the current assets and therefore greatly improved the current asset position.

How will you deal with these facts in the balance-sheet and certificate?

*Answer:*

The notes should be shown in the balance-sheet as follows:

Notes receivable—sale of idle plant:

Due January 27, 1934 . . . . .	\$ . . . . .	
Due February 26, 1934 . . . . .	\$ . . . . .	\$ . . . . .

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Because the note due on January 27, 1934, was not paid at maturity, I would show these notes as a separate item in the balance-sheet, following the current asset section.

The resulting profit or loss on the sale should be shown separately in the surplus section of the balance-sheet.

In the certificate (which should be dated) I would include a paragraph stating that the idle property was sold on December 28, 1933, at a price of \$ . . . . . , payable one-third in cash, one-third in a note due on January 27, 1934, (which was not paid at the date of the examination) and one-third in a note due on February 26, 1934.

*American Institute Examinations, problem No. 7.—November 15, 1934*

Palisades Park, N. J.

*Dear Sir:*

Referring to your solution in the March, 1935, issue of THE JOURNAL of problem No. 7 of the American Institute examinations given November 15, 1934, I would contend, as accountant for the film company, that my client was entitled to \$387.09 in rental.

It is my theory that the expenses should be prorated over the entire sales, and that the gross profit on sales is uniformly 60 per cent. for the period. My solution, using this theory, is attached.

This letter is not written in a spirit of criticism, but merely to present the possible attitude of the officials of the film company.

Very truly yours,

(Sgd.) EDMUND J. CONWAY,  
Certified Public Accountant (New York)

Let  $X$  = Total rental

Let  $Y$  = Gross receipts on which 15% rental is paid

\$1,000 =  $Y$  = Gross receipts on which 50% rental is paid

.15  $Y$  + .50 (\$1,000 =  $Y$ ) =  $X$

.60  $Y$  = Profit on gross receipts on which 15% rental is paid

$\frac{X}{2}$  = Profit on gross receipts on which 15% rental is paid

.60  $Y$  =  $\frac{X}{2}$

1.2  $Y$  =  $X$  or

1.2  $Y$  = .15  $Y$  + .50 (\$1,000 =  $Y$ )

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1.2  $Y = \$500 - .35 Y$   
1.55  $Y = \$500$   
 $Y = \$322.58$   
 $\$1,000 = Y = \$677.42$   
15% of  $\$322.58 = \$ 48.38$   
50% of  $\$677.42 = \underline{338.71}$

Total rental..  $\$387.09$

Proof: Gross receipts on which 15% rental is paid.....	$\$322.58$
Less expenses (40%).....	<u>129.03</u>
Profit thereon or $\frac{1}{2}$ of total rental.....	<u><u><math>\\$193.55</math></u></u>

*Reply:*

Several letters have been received commenting upon this problem; the solutions offered by the writers have all been based upon the assumption that the expenses, other than film rentals, should be applied ratably against the receipts, apparently upon the theory that they varied (at 40%) with the gross receipts. There is nothing in the problem to indicate either the nature of these expenses, which total \$400, or the manner in which they are to be applied against the gross receipts. Since from the nature of the theatre business a great part of the expenses (other than film rental) are known to be virtually fixed, the expenses were applied against the first receipts in the published solution. This would appear to be the preferable interpretation.

## Correspondence

### ACCOUNTANCY CONCERNED WITH FINANCIAL FACTS

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: Maurice E. Peloubet's review of Arthur Stone Dewing's *The Financial Policy of Corporation* deserves comment.

Mr. Peloubet touches on one point where economists and accountants often clash. Economists are always prating about "value"; they demand that accountants focus their attention on "values." But the theorist's concept of "value" is not only vague and nebulous but belongs to the uncertain realm of philosophy and is unfit for use in a "pragmatical science." There are as many theories of "value" as there are schools of economy; and as quickly as one theory is found untenable and its head cut off two new hydra-headed theories spring up to take its place.

Mr. Peloubet, as an accountant dealing with realities, points out that accountancy must deal with "financial" in contradistinction to "economic" facts. Accountancy presents these facts in "conventional units by conventional means." Since all the world is aware of these conventional units and conventional methods, nobody need be misled. The very fact that these conventions are thoroughly understood makes the financial reports of accountants available, so that they may be adjusted by any who have the folly or transcendent wisdom to do so, to reflect any theory of value or of money.

"Here are the figures, and here are the well-known methods of compilation," says the accountant, "and if you wish to adjust them for the new gold-content of the dollar, or the changing price-index numbers, or because of the influence of the tariff, or to account for changing sun-spots, go right ahead." Fortunate, indeed, are the "interpreters" that accountants agree so much as to conventions and do not "interpret" too much in advance of compilation!

And no matter how Einstein heads his rays of light he will rely on the fact, when he takes his daily walk, that a straight line is the shortest distance between two points.

Indeed, it is better sometimes that certain rules and guides be "fixed" rather than theoretically correct and true. That goes for many phases of life: the calendar, the foot-rule, the clock and in the whole field of law. The whole doctrine of English law is based on the recognition of this principle. That is the essence of the doctrine of "stare decisis." Even "language" is a convention.

Why should accountants introduce more uncertainties into their unexact science?

Yours truly,

HAROLD A. EPPSTON

Newark, New Jersey, January 7, 1935.

## Book Reviews

WHOLESALE ACCOUNTING AND CONTROL, by J. BROOKS HECKERT and IRVING J. STONE. *McGraw-Hill Book Co., Inc.*, New York. Cloth, 234 pages. 1935.

According to the *Accountants' Index*, there has been little written about accounting for wholesale merchants, and even that little relates to retail or general systems of accounting or appears in magazine articles. So *Wholesale Accounting and Control* should be welcomed by accountants and managers in the wholesale trade, particularly in small or medium concerns. It is, in fact, an attempt to give the smaller firms and corporations the benefit of a scientific system worked out by the larger. Written by an educator, Prof. Heckert, of Ohio state university, and Mr. Stone, controller of a large wholesale corporation, it is a happy combination of theory and practice.

Profusely illustrated with forms and written in a clear and easy style, the book, in the first eleven chapters, which cover standard accepted methods of recording and analyzing transactions, is a practical manual for the accounting department. The remaining ten chapters, dealing with standards, budgeting and control, will be of more interest to managers, and although they are "counsels of perfection," which controllers and managers dream about but seldom attain, they point the way to better and sounder business practices. An appendix contains practical examples of the application of the principles developed in the text.

W. H. LAWTON.

PARTNERSHIP ACCOUNTS, by R. STORM MACKAY. *Gee & Co.*, London. Cloth, 260 pages. 1935.

*Partnership Accounts* is a practical manual for students, in accordance with English laws and customs. A preliminary chapter on the law of partnership is wisely confined to bare elements, the bulk of the book being given to various problems, well illustrated by concrete examples, concerning distribution of partnership profits, adjustment of accounts in reorganizations, terminations, etc. Substituting dollars for pounds, it is a handy manual for American students if read in connection with the uniform partnership act which is very similar to English laws.

In the light of recent events in this country it is interesting to note that by the English law of 1929 "no more than twenty (in the case of banks ten) persons are permitted to be associated in partnership."

W. H. LAWTON.

## Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are 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.]

### PARTNERSHIP ACCOUNTS ON BALANCE-SHEET

*Question:* An opinion is requested as to the proper balance-sheet presentation of the accounts of a partnership. A trial balance of the accounts follows:

Cash . . . . .	\$	3,550.80	
Accounts receivable . . . . .		74,650.00	
Investments . . . . .		490,830.20	
Deferred charges . . . . .		14,624.43	
Notes payable . . . . .			\$309,310.09
Accounts payable . . . . .			217,933.11
A, capital . . . . .			102,872.70
B, capital . . . . .			96,852.95
C, capital . . . . .			35,355.26
D, capital . . . . .			34,972.43
E, capital . . . . .			35,308.38
F, capital . . . . .			30,389.20
G, capital . . . . .		279,338.69	
		\$862,994.12	\$862,994.12
		\$862,994.12	\$862,994.12

The only question at issue relates to the debit balance in G's capital account. Should this item be shown as an asset on the partnership balance-sheet, or should it be shown as a deduction from the sum of the other partners' capital?

*Answer No. 1:* The trial balance contained in the above question indicates that there are total assets of \$583,655.43, consisting of cash, accounts receivable, investments and deferred charges, and that liabilities amount to \$527,243.20, consisting of notes payable and accounts payable. The partnership's net equity in the assets is, therefore, \$56,412.23, which is represented by



credit balances in the partnership accounts of A, B, C, D, E and F, amounting to \$335,750.92, less a debit balance in the capital account of G of \$279,338.69.

No mention is made of the purpose for which the partnership balance-sheet is to be issued, but as the purpose of a balance-sheet is usually to set forth, for the purpose of obtaining credit, the partnership's net worth, it would appear reasonable to expect that, in the preparation thereof, any debit balances in the capital accounts would be deducted from the respective partnership credit balances, thereby showing the amount of the net capital investment. It must also be borne in mind that any loss, which may be occasioned by the inability of the partnership to collect the debit balance of any partner, is chargeable against the accounts of the remaining partners.

If a member of a partnership is permitted not only to withdraw his entire capital but also an amount which represents a portion of the capital investment of other partners, it is our opinion that no accountant is justified in showing the debit balance as an asset of the partnership. To do so would subject him to ridicule and criticism.

*Answer No. 2:* I believe that this should be shown in this manner and not among the assets. Only in this manner can the actual capital employed be indicated. Furthermore, this allows the statement to show the total assets which are in the business available for the payment of amounts due to creditors entirely apart from the claim which may be made against any or all of the partners for any deficiency.

*Answer No. 3:* Our opinion is that it is better to show partners' capital in circumstances outlined in the question as credit balances less the debit balance of \$279,000, carrying out a net figure.

There might be an exception in this case if the advance was for a short time and was secured or there was no question that G was entirely solvent and willing to repay the amount. In this case the account due from G might be shown as an asset owing by a partner under separate caption, preferably with some particulars as to securities or other circumstances justifying the carrying of the asset.

#### *SUBORDINATION OF STOCKHOLDERS' NOTES TO BANK DEBT*

*Question:* The following is a summarized balance-sheet of a corporation engaged in manufacture:

Current assets:			
Cash . . . . .	\$ 36,000		
Customers' receivables, less reserves . . . . .	109,000		
Merchandise inventory . . . . .	85,000	\$230,000	
Other assets:			
Plant, less depreciation reserves . . . . .	\$ 45,000		
Intangibles . . . . .	67,000		
Investments . . . . .	14,000	\$126,000	
Total assets . . . . .		\$356,000	

## Accounting Questions

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Deduct—liabilities:		
Notes payable:		
Bank . . . . .	\$32,000	
Stockholders, subordinated to the bank debt . . . . .	45,000	\$77,000
Accounts payable and accrued ex- penses . . . . .	35,000	\$112,000
Net worth, represented by preferred and common capital stock . . . . .		\$244,000

Operating losses for the past three years have been considerable; prior to that time the corporation had been successful for many years.

The notes payable to stockholders are in possession of the bank and are subordinated to the bank debt. The corporation's financial statement is available to stockholders, banks and other credit agencies.

*Questions—*

- (a) Should the fact that the notes payable to stockholders are subordinated be disclosed in the balance-sheet?
- (b) Two months after the balance-sheet date the bank was paid and the subordination lifted. The corporation delivered its balance-sheet to the trade after eliminating reference to the subordination. Should the professional accountant receiving a request from the trade asking confirmation of the corporation's statement refer to such subordination?

*Answer No. 1:* It would certainly seem correct to refer to anything which affected the rank of the various liabilities, such as the subordination of the stockholders' notes. I should think on the whole that the statement of such subordination would strengthen rather than weaken the company's statement from the point of view of other creditors, as it would be clear that the stockholders in their character of creditors would not enforce their rights against any others.

I do not see what motive the corporation would have in eliminating reference to such subordination in a statement issued after the subordination was removed, but as of the date when the subordination was still in force. It would be well from the corporation's and the accountant's point of view to mention that such a concession had been made by the stockholders.

It would seem to me the best thing to explain to the client that this subordination of stockholders' notes strengthened rather than weakened the statement and to suggest that conditions subsequent to the date of the balance-sheet should not be given effect in the balance-sheet, but that an explanatory note could be added if it was considered desirable.

The question is an unusual one and it is not impossible that I have missed the point which the inquirer had in mind.

*Answer No. 2:* The first question asks, in the circumstances noted, whether or not the fact of subordination of obligations to stockholders in favor of bank creditors should be noted on the balance-sheet. Inasmuch as this arrangement does not necessarily involve the corporation, but is a private matter between

two creditors, I can not see why reference need be made on a published balance-sheet. A corporation is not necessarily a party to any such arrangement and no other creditor is discriminated against or favored by the fact of the subordination, nor are the stockholders as such affected by it.

The second question asks whether professional accountants receiving a request from a member of the trade, after the subordination had been lifted, should refer to such subordination. The same reasoning follows in respect to this question. I do not see why reference need be made to the subordination.

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