Journal of Accountancy

Volume 45 | Issue 3

3-1928

Journal of accountancy, March 1928, Vol. 45 issue 3 [whole issue]

American Institute of Accountants

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Issued Monthly by

THE JOURNAL OF ACCOUNTANCY, INCORPORATED, Publishers

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

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

President, CARL H. NAU
Treasurer, J. E. STERRETT
Secretary, A. P. RICHARDSON
3334 Prospect Ave.
56 Pine Street
135 Cedar Street
Cleveland, Ohio
New York, N. Y.
New York, N. Y.

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

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Before the enactment of the revenue act of 1909 depreciation practice in a great number of industrial organizations was not only unscientific but often capricious. A year of small profits would often be charged with no depreciation at all, and a year of business prosperity would be charged with an amount wholly inadequate for its purpose. After a year of good business the management would gauge by the amount of the profits the extent to which depreciation of plant and equipment had been sustained during the year, so that depreciation as recorded frequently measured fluctuations of income rather than the effect of time, wear and tear.

Those who made regular provision for depreciation usually wrote down the asset accounts by yearly credits to reduce them to values fixed at the end of the year. These values often were set after consideration had been given to reality fluctuations and other unrelated factors. In many instances a fixed percentage was employed, but in utter ignorance of the results it accomplished and to avoid the necessity of opening separate accounts for depreciation reserves. A rate of say 10 per cent. might be used which, through its application against an ever diminishing balance, effected a constantly decreasing allowance and never completely removed the cost of the asset from the books. While sometimes accountants are still found who regard it as the proper method, because of the fact that there is a decreasing write-off in successive years offset by ever increasing charges for repairs, its employment has always been frowned upon by the income-tax unit and it has practically gone into disuse together with the antiquated method of writing off depreciation in accordance with the size of the profits for the year.

Section 38 of the revenue act of 1909 allowed as a deduction from income subject to tax "a reasonable allowance for depreciation of property." In view of the fact that the rate of tax under that act was only 1 per cent. of net income, consideration of the precise meaning of the term depreciation so as to assure
correct and adequate provision in arriving at the taxable income was not of much importance to smaller companies. It did, however, become important in the case of companies whose investment in equipment was large, with a consequently great amount of exhaustion, and the question came to issue in the suit of San Francisco & P. S. S. Co. v. Scott, collector (Fed. 854). In that case it was held that

"Depreciation, as used in the statute ... is intended to cover the estimated lessening in value of the original property, if any, due to wear and tear, decay or gradual decline from natural causes, which at some time in the future will require the abandonment or replacement of the property, in spite of current ordinary repairs."

Not until the revenue act of 1917 came into effect did depreciation deduction become one of the major items of consideration in the tax return of the average company. In that act, however, the tax on income reached the unprecedented rate of over 60 per cent and in the act of 1918 the tax was over 80 per cent. in certain cases. Under such conditions a deduction of each $1,000 of depreciation might result in a saving of $824 in taxes as against $10 under the act of 1909. Consequently, many disputes relative to depreciation arose between taxpayers and revenue agents, particularly in the year 1918, and a general awakening to the importance of proper classification of capital and revenue expenditures was also noticeable. The disputes which arose often turned about the question of what rates were reasonable, the taxpayer usually going to one extreme and the revenue bureau to the other.

In addition to its effect on net income, the special provisions of the excess-profits tax made the correct deduction for depreciation of outstanding importance through the necessity of arriving at proper net values of assets for purposes of invested capital. Wrong depreciation, of course, results in an incorrect statement of the cost of product and of other operating costs in addition to misstatement of assets, but its ill effects are most quickly realized in the repeated and annoying adjustments made by revenue agents.

Aside from the residual or final scrap value of assets, which is at best a pure guess, there are only two factors involved in the computation of the depreciation deduction, viz., the cost and the useful life of the asset. The cost of an asset is, in ordinary circumstances, quite easily determined; or, if March 1, 1913, values are applicable instead of cost, such values have in practically all cases of depreciable assets been agreed upon between the tax-
payer and the revenue department. In most cases there has also been mutual assent as to the rates to be used.

With the removal of all controversy relative to the two factors needed for computation of depreciation, it might be assumed that deduction of the proper amount is now assured in practically all future tax returns. This assumption, however, is very far from true. It is true that ordinarily the rates agreed upon are maintained, but through omissions of charges to the asset accounts for legitimate capital additions, transferred from repair accounts by the revenue agents, or because of a strained interpretation of the law emanating from the income-tax unit (e.g., I. T. 2356) as well as through other causes, the basic figures upon which depreciation is allowable often become obscured.

Though there are, as mentioned, occasionally other causes which complicate the computation of depreciation, most errors, by far, arise from the fact that adequate records are not kept. If one account only were kept for all accounts receivable it would not take more than one month for difficulties to develop. It would be difficult to ascertain the amount owing by most of the customers; it would be impossible to follow up delinquent accounts; proof of the correctness of even the total asset could not be obtained, the figures shown becoming in fact more and more fictitious as time went on. Obviously a capital-asset account fares no better unless a detailed plant ledger is kept, the aggregate amount of which is periodically reconciled with the figures reflected in the capital-asset account on the general ledger. Without such a record the actual cost of the present plant and equipment soon becomes an unknown quantity with the result that from time to time appraisals are considered necessary to get a new start. Even appraisals, however, are not satisfactory, for it is impossible to reflect therein actual cost, since the years of purchase of all assets can not be definitely ascertained.

Nearly all record of the individual items comprising the plant investment having been lost, the basis for depreciation is likewise lost. In the absence of a better basis, the rate of depreciation in use is applied against the balance shown in the capital-asset account year after year.

Obviously, such a method, or rather lack of method, leads eventually to a condition where the amount shown in the reserve for depreciation is absolutely void of significance. As one of the direct results, depreciation is taken on assets no longer in exist-
ence, or on those which have been fully provided for through depreciation of past years.

With this in mind an examining revenue agent makes an attempt to get at the allowable depreciation as nearly as incomplete records will permit. As a result some depreciation is almost always disallowed.

If the method of compilation often used by revenue agents is followed to its conclusion, the final result is the reversal of all depreciation previously granted. Having deducted an allowance on a ten-year asset for the full ten years, it should now be considered no longer. However, its dismantlement, with consequent removal from the asset account at the end of that period, causes a credit equal to its cost (which must often be estimated because of inadequate records) to appear in the asset account. This credit, of course, applies against assets now eliminated in the computation of depreciation, but because of lack of complete data as to when the assets were purchased, it is offset against the cost of assets acquired in the current year. By calculating depreciation on the net asset additions for the year, the depreciation allowed in the first ten years in respect of the asset dismantled is reversed by deduction in the succeeding ten years. Certainly the cost of an asset disposed of should be taken out of the charges of the year in which it was acquired, the additions for that year having usually been fully depreciated, and should not be applied against the additions of a year for which depreciation is still allowable.

To show some of the far-reaching effects of incorrect methods used, the following examples are offered. In each of them the rate of 25 per cent. is used for convenience. Example I shows the over-depreciation resulting when fully depreciated assets are not taken out of the asset balance used for calculating depreciation. Example II shows the result of the arbitrary allocation of dismantlements and discarded assets to the year of discard rather than to the year of acquisition. In example III the additions and the deductions of the year 1925 are applied to the years of purchase. The figures $45,375, $12,250 and $33,125 are respectively the amount deducted by the taxpayer, the amount allowed by the revenue agent and the amount which would be allowable if proper records were kept.

**EXAMPLE I**

The taxpayer's usual method takes full depreciation on the balance in the asset account at the beginning of the year and one half
Depreciation Practice and Plant Records

of the yearly rate on assets acquired during the year. This results in excessive depreciation to the extent of assets fully depreciated in prior years.

<table>
<thead>
<tr>
<th>Asset account</th>
<th>Depreciation taken</th>
</tr>
</thead>
<tbody>
<tr>
<td>$165,000</td>
<td>25% $41,250</td>
</tr>
<tr>
<td>$33,000</td>
<td>4/5 of 25% $4,125</td>
</tr>
</tbody>
</table>

Balance of account Jan. 1, 1925 $165,000
Additions for year, net 33,000
Balance, Dec. 31, 1925 $198,000

EXAMPLE II

The effect when assets disposed of are not applied to the year in which they are acquired may be seen in the method usually adopted by revenue agents. The asset account shown in the preceding example is divided to show the net yearly changes in the account which compose the total of $198,000 shown in example I.

Composition of asset account showing net additions by years

<table>
<thead>
<tr>
<th>Year</th>
<th>Value</th>
<th>Depreciation allowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1920</td>
<td>$100,000</td>
<td>Fully depreciated</td>
</tr>
<tr>
<td>1921</td>
<td>65,000</td>
<td>1/2 of 25% $8,125</td>
</tr>
<tr>
<td>1922</td>
<td>4,000</td>
<td>25% $1,000</td>
</tr>
<tr>
<td>1923</td>
<td>10,000</td>
<td>25% $2,500</td>
</tr>
<tr>
<td>1924</td>
<td>6,000</td>
<td>25% $1,500</td>
</tr>
<tr>
<td>1925</td>
<td>33,000</td>
<td>1/4 of 25% $4,125</td>
</tr>
</tbody>
</table>

$198,000 $12,250

EXAMPLE III

The method based on correct principles, under which assets sold or discarded are properly allocated, is shown as follows:

Composition of asset account Jan. 1, 1925 by years of purchase

<table>
<thead>
<tr>
<th>Year</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1920</td>
<td>$30,000</td>
</tr>
<tr>
<td>1921</td>
<td>16,000</td>
</tr>
<tr>
<td>1922</td>
<td>20,000</td>
</tr>
<tr>
<td>1923</td>
<td>54,000</td>
</tr>
<tr>
<td>1924</td>
<td>45,000</td>
</tr>
<tr>
<td>1925</td>
<td>58,000</td>
</tr>
</tbody>
</table>

Composition Changes at Dec. 31, 1925 Correct depreciation

<table>
<thead>
<tr>
<th>Year</th>
<th>Value</th>
<th>Value</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1920</td>
<td>$30,000</td>
<td>$30,000</td>
<td>Fully depreciated</td>
</tr>
<tr>
<td>1921</td>
<td>13,000</td>
<td>13,000</td>
<td>1/2 of 25% $1,625</td>
</tr>
<tr>
<td>1922</td>
<td>13,000</td>
<td>13,000</td>
<td>25% $3,250</td>
</tr>
<tr>
<td>1923</td>
<td>45,000</td>
<td>45,000</td>
<td>25% $11,250</td>
</tr>
<tr>
<td>1924</td>
<td>39,000</td>
<td>39,000</td>
<td>25% $9,750</td>
</tr>
<tr>
<td>1925</td>
<td>58,000</td>
<td>58,000</td>
<td>1/4 of 25% $7,250</td>
</tr>
</tbody>
</table>

$165,000 $33,000 $198,000 $33,125

A comparison of the results makes further comment unnecessary. The error of both the first and second methods is seen at
once. Even the method set out under example III is deficient to some extent in that it treats assets in the aggregate and not as specific units.

If, instead of crediting the asset account with the cost of assets discarded, the selling or salvage value only is credited, the results shown in example II are partly overcome because yearly depreciation will thereby be reduced by only the amount applying against such residual value and will eventually be allowed on the "value in use" of the entire asset. However, aside from overstatement of the asset on the balance-sheet, the depreciation charge is affected in years when the asset no longer exists, being overstated in the period immediately succeeding and understated thereafter. Moreover, the revenue agent may of right transfer the entire realized scrap value to income because the date of acquisition and the cost are not known and it is not unfair to assume that the asset has been fully depreciated.

In the foregoing only one point has been considered, that of allocation of assets to years of acquisition. No attention has been given to the result of the customary use of a fixed rate. It is generally intended that the rate used be an average or composite rate, in which is reflected the span of life of all the assets collectively. Four machines costing $1,000 each, having a composite life of twelve years, require an annual provision of $333.33, or 8½ per cent. of cost. If, however, analysis of the assets shows that the lives of the four machines are respectively 4, 9, 15 and 20 years, it is apparent that depreciation taking place is as follows:

<table>
<thead>
<tr>
<th>Machine</th>
<th>Life</th>
<th>Annual provision</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>4</td>
<td>$250.00</td>
<td>25%</td>
</tr>
<tr>
<td>B</td>
<td>9</td>
<td>111.11</td>
<td>11½%</td>
</tr>
<tr>
<td>C</td>
<td>15</td>
<td>66.66</td>
<td>6½%</td>
</tr>
<tr>
<td>D</td>
<td>20</td>
<td>50.00</td>
<td>5%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$477.77</td>
<td></td>
</tr>
</tbody>
</table>

When these rates are applied, depreciation for the first four years is $477.77 annually, or 11.94 per cent. of the total cost of $4,000. After that time machine A would be fully depreciated and the annual provision decreased by $250. The results for the following years would then be:

5 years, $227.77, annual provision, or 7.59% of asset values
6 " 116.66 " " 5.83% " " "
5 " 50.00 " " 5.00% " " "

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Depreciation Practice and Plant Records

It will be noted that with each new asset acquired and with each asset discarded, the composite life, and therefore also the rate, changes.

If it were possible to determine accurately the real average life of the aggregate of assets; if each asset were replaced at the end of its life; if the cost of the new asset did not differ from the cost of the replaced asset; and if the ratio of 4-year, 9-year, 15-year and 20-year assets to total assets were always maintained, then the use of an average would commend itself. However, such an ideal situation can be conceived but not attained and the method, though easy of application, leads to a hopeless condition of the reserve for depreciation.

The matter is even worse than at first appears because at the time the 4-year asset is discarded an attempt is made to adjust the asset and reserve accounts to reflect the changed values. Based on the average rate of 8 1/2 per cent., the asset is now considered only 1/3 depreciated on the books, wherefore an entry is made to surplus recording as a loss 2/3 of the cost of the asset, a loss which does not in fact exist. On the contrary, should the 20-year asset be dismantled after 12 years, the loss of the remaining 8/20 of the original cost would be entirely ignored in the records.

It is quite obvious then that the use of a flat or composite rate of depreciation on a group of assets is misleading and results in fictitious net valuations and inaccurate depreciation charges.

The examples given are not exhaustive and there are many more by which the need of better records of plant equipment could be shown. No mention has been made of cases arising under insurance-loss adjustments nor of the need of proper records as a guide to the amount of insurance which should be carried. Likewise, nothing has been said of the need of proper records to permit a check on the accuracy of the estimated depreciation rates or as a basis for allocating the correct amount of depreciation to departments for purposes of accurate cost finding. The inadequacy of usual records, because of failure to provide a check on disappearing assets, and in the case of an expected quick sale of the entire plant and equipment or of even a specific group of assets, has also not been discussed. Every accountant knows of cases in which the capital-asset account represents nothing but a conglomerate mass of figures which are carried only because no better information is available.
Sometimes an appraisal is ordered in an attempt to resurrect the correct asset values and to adjust the book figure to a significant amount. After the appraisal, question then arises as to how much of the difference between appraised values and book figures arises from each of the following causes:

(a) Errors in computation of depreciation.
(b) Neglect to remove the discarded assets from the asset account.
(c) Erroneous rates of depreciation.
(d) Errors in making the appraisal.
(e) Pure appreciation (the sin of today’s reproductive-values theory).

The errors arising from (a) can be entirely eliminated by keeping a proper plant ledger; those arising from (b) and (c) could be adjusted so regularly and with such little difficulty through the use of a plant ledger that the effect would not be sufficient to cause even a ripple in the yearly profit-and-loss statement; those of (d) would seldom arise because appraisals would be unnecessary, except for prospectuses, and those of (e) could not occur except by intent. The whole requirement is a proper plant ledger kept by departments, enabling the foreman of each department once or twice a year, preferably during the slack season, to review his section and report any assets his department no longer has. Obviously assets such as small tools should not be charged into the plant ledger but one of the usual practices such as that of inventoring the tools annually should be adopted.

Considered from all angles, the plant ledger is of undeniable benefit and its absence in many corporations is excused only by the contention that its upkeep involves a great amount of labor and expense. It is, of course, true that some labor is necessary for the installation of such a record. However, once installed, the work under a proper system is easily managed. In fact, if the conditions arising from a lack of such a record were fully realized, it would be found that in many cases the saving of tax and of time in tracing back the cost and depreciation on assets sold or discarded would more than offset the time required in its maintenance. Great care is exercised to show the other assets on the yearly statement at correct values. In fact, meticulous exactitude is often exercised to show deferred charges which sometimes have no intrinsic value and are set up merely to relieve surplus account of excessive charges in one year, viz., organization expense, ex-
Depreciation Practice and Plant Records

perimental expense, etc. down to the last cent. Yet any errors in the values of all these will probably adjust themselves in the subsequent year. On the other hand, incorrect statement of plant values has a permanent effect on surplus.

The greatest obstacle to the installation of a plant ledger arises from the necessity of an inventory of plant equipment for a proper beginning. Without doubt such an inventory is highly desirable and as a basis for a plant ledger an appraisal is to be recommended. However, as previously noted, many difficulties arise when an appraisal is made and the resultant figures are almost always in excess of book figures. Conservatism and sound accounting demand that no element of appreciation be reflected in the books. Therefore, instead of writing up the asset account, the appraisal should be used as a basis or inventory only and as many of the assets as possible should be repriced at actual invoice prices and the amount thereof transferred to a new plant-assets controlling account. It will be found that in the majority of cases it is possible to ascertain the costs. Where, however, this can not be done it will generally be practicable to establish them by correspondence with the makers of the equipment. A comparatively small group of the assets must then be priced by scaling down the appraised figures to meet the remaining balance in the old asset account. These figures will, of course, not be very accurate but they will serve as a beginning towards proper practice and will serve to lead the way out of an apparently hopeless situation.

Depreciation on all the assets listed in the appraisal must then be taken at rates representing their remaining life. An estimate of this can be made quite easily as the appraisal will show the percentage that each asset has depreciated to the date of the appraisal. Aside from the fact that the appraisal furnishes a fairly complete inventory, it often conveys a comprehensive revelation of the extent to which neglected records are deceiving. It may be found that a plant considered depreciated only to 75 per cent. of its value actually reflects a shrinkage of 50 per cent.

Some people object to the expense of the appraisal and to them a physical inventory of all equipment by employees is recommended. This inventory could be priced from such invoices as are available and the depreciation calculated on each asset. The cost and dates of purchases of such assets for which invoices are not available would have to be learned from the manufacturers. This can be done in most cases if the serial number of the machine,
which usually appears on some part of it, is given. Adjustment
is then necessary to reflect the figures so compiled, but for pur-
poses of income tax any balance of the asset account not accounted
for must be depreciated at the rate previously used until the bal-
ance is entirely exhausted.

This method, of course, entails time and work and objection is
therefore often made to it. Yet even those who do not care to go
to this trouble may work toward perfection gradually by starting
a plant ledger containing only the larger assets which are long-
lived, and transferring only the cost and accumulated depreciation
of these to the new plant-ledger and reserve-for-depreciation con-
trolling accounts. All new plant equipment purchased there-
after may then be accounted for in the proper manner and the re-
serve against the old unidentified capital assets, the cost of which
was not transferred, will eventually equal the corresponding
asset account and so both will vanish. It is possible under this
arrangement constantly to come closer to the ideal by transferring
from time to time from the old asset and depreciation-reserve ac-
counts to the plant-ledger controlling account as many of the un-
identified assets as time for analysis of past purchases will permit.

The mere fact that the accounts may not be placed on an en-
tirely satisfactory basis immediately affords no reason for failure
to make a start. Even if a plant ledger at its inception contains
only current purchases and entries, there will at least be a trend in
the right direction and in ten years' time most of the plant equip-
ment and furniture will be accounted for in the new record.

The human being is always anxious to follow the line of least
resistance. In some respects this trend is highly commendable
because it has resulted in the invention of most of our labor-saving
devices. Only the urge of necessity makes one keep records at
all and even then there is a constant weighing of the results ob-
tained against the work entailed. Such is the case with the plant
ledger. Often its value is underestimated; more often, however,
the work of upkeep is overestimated. The following list of rules
is suggestive of a plan by which a plant ledger may be kept with
a minimum of labor:

1. The depreciation set up monthly in the reserve-for-depreciation
   controlling account should be based on the balance of the asset at
   the beginning of the year, plus one half the estimated additions for
   the current year, and the figure so obtained adhered to unless a
decided change occurs in the amount of the asset account.
2. The adjustment to exact figures should be made only once a year.
3. This adjustment should be made in the month prior to the last month of the year and the correct depreciation for the last month determined then to avoid crowding in the closing month.
4. The yearly depreciation of each asset acquired should be spread on the plant-ledger card for the entire estimated life at the time of acquisition, to save posting in detail at the end of each period.
5. The depreciation of each asset should be shown in cumulative figures for each year rather than in the amount of the provision for each year.
6. Depreciation on assets should be carried to the end of the year in which discarded, except in the case of very large items which might distort the figures too greatly.
7. The plant-ledger sheets or cards on assets discarded should be segregated as these occur and one entry made at the end of the year for all assets so discarded, the discarded sheets then being bound together by years.
8. A fixed place on each sheet should be used for the depreciation accumulated to a certain date and the years printed in. Failure to take this precaution increases the work with respect to this item probably as much as tenfold and this is one failing of practically every plant-record card that is met with in practice.
9. Plant-ledger sheets should be opened for the purchases regularly at the lightest time of the month.
10. Additions under a fixed, reasonably small amount, depending upon the size of the company and the nature of the assets used, should be charged to expense when acquired and no asset with an estimated life of no more than one year should be capitalized.

Many variations in the forms of records which may be used suggest themselves. Some accountants prefer cards and others loose-leaf ledger sheets, each of which has certain advantages. Cards are more flexible than ledger sheets and are therefore generally employed. The chief thing to bear in mind is to have all essential information on the records and to have a fixed place for the amount of accumulated depreciation at the end of each particular year. The card shown on page 172 is suggestive only and each plant will find it convenient to have it contain certain other information having utility in the individual organization. It will be noted that each third line is shaded to aid the eye in finding the amount in any particular year. This enables one to prepare
very rapidly an adding-machine tape of the total depreciation accumulated on all assets.

A plate with a serial identification number attached to each machine will facilitate a check on the asset and also the quick culling of its card.

<table>
<thead>
<tr>
<th>Machine number 478 Shaper</th>
<th>Life 20 years</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bought</strong></td>
<td><strong>Depreciation accumulated at December 31st.</strong></td>
</tr>
<tr>
<td>10/6/27 VR 14860</td>
<td>764.00</td>
</tr>
<tr>
<td>American Mach. Co.</td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>9.05</td>
</tr>
<tr>
<td>28</td>
<td>47.25</td>
</tr>
<tr>
<td>29</td>
<td>85.45</td>
</tr>
<tr>
<td>30</td>
<td>123.65</td>
</tr>
<tr>
<td>31</td>
<td>161.85</td>
</tr>
<tr>
<td>32</td>
<td>200.05</td>
</tr>
<tr>
<td>Sold or scrapped</td>
<td></td>
</tr>
<tr>
<td>12/31/45</td>
<td>50.00</td>
</tr>
<tr>
<td>33</td>
<td>238.75</td>
</tr>
<tr>
<td>34</td>
<td>276.45</td>
</tr>
<tr>
<td>35</td>
<td>314.65</td>
</tr>
<tr>
<td>36</td>
<td>352.85</td>
</tr>
</tbody>
</table>

(Size 5" x 8")

The procedure is as follows: After the general-ledger accounts have been closed for the month a card similar to that shown is prepared for each piece of plant equipment acquired during the month. The yearly depreciation provision based on the probable life of the individual asset is at once calculated and spread on the card in cumulative figures to the end of the asset’s expected usefulness. The cards are arranged according to departments and by serial numbers for convenience in finding them and to make separate balancing of those appertaining to each department possible. This makes it possible also to charge each department only with its own depreciation.

At the end of each six-months period the amounts shown under the bought section of all cards are balanced with the controlling accounts to assure that cards have been prepared for all additions. The depreciation section need be balanced only once a year. Proceeds of sales have been applied on the cards as received so that in the case shown above the balance would be $714, and this amount, less the accumulated depreciation of $696.65, is charged out at the end of the year. The plan intends that in the month preceding the close of the year, or preferably twice a year, all cards be gone over with the foremen of the respective departments, the cards for assets no longer in existence segregated, and investiga-
Depreciation Practice and Plant Records

A depreciation list must be made of the asset figures appearing on the cards and also one of the depreciation accumulated to that date on all assets still carried. Separate lists must also be made of the cards segregated because of non-existence of the assets. Adjusting entries are now necessary and the adding-machine lists should be fastened to the vouchers on which the entries appear, the segregated cards being properly filed in permanent form. To illustrate the nature of the adjusting entries the following example is given:

Information:
Ledger:
- Total of asset controlling account at end of period: $17,665.00
- Total of reserve account, including monthly provision for eleven months: 7,341.00

Cards:
- Assets still on hand: 16,745.00
- Assets no longer existing, as per segregated cards: 920.00
- Accumulated depreciation on assets still on hand (to end of year): $7,684.00
- Accumulated depreciation on assets no longer existing (to end of year): 818.00

Dr. Cr.

Journal entries:
1. Profit and loss on sale of capital assets: $920.00
   - Capital assets: $920.00
   - To reduce capital asset account in respect of assets sold and discarded.

2. Reserve for depreciation: 818.00
   - Profit and loss on sale of capital assets: 818.00
   - To transfer depreciation on assets sold and discarded.

3. Profit and loss—Depreciation: 1,161.00
   - Reserve for depreciation: 1,161.00
   - To provide depreciation for year ($8,302.00 - $7,341.00).

By carrying the depreciation on assets discarded to the end of the year a small amount would, of course, be charged to depreciation which would ordinarily be charged to profit and loss on sale of capital assets. However, such amount would usually be very small and would perhaps not even offset underdepreciation in another asset for the year. If greater accuracy is desired the depreciation on assets dismantled before July 1st may be stopped as of December 31st of the previous year thus giving effect to an average for the year.

The card shown provides for a period of 40 years. Some question might be raised as to whether or not two cards will be necessary for
assets acquired in the late years shown on the cards, and also some objection raised that it will be necessary to make new cards for all assets in the year 1967. The difficulty may be avoided by having, on the opposite side of the card, spaces starting with that year, these beginning at the exact place where the year 1927 appears on the face of the card. From the year 1967 forward new cards are made only for assets acquired from then on, the faces of these beginning with the year 1967, or in register with the backs of the old cards, and the reverse sides with the year 2007. By drawing a red line across the depreciation section of all cards beginning with the year 1927, when 1967 is reached all confusion as to which is the active side will be avoided. As mentioned before, the important point to remember is "a fixed place for the accumulated depreciation at any one date." Adding-machine slips can then be run off in a small fraction of the time which would be required if each card necessitated a careful inspection to ascertain the amount applying to the particular year.

Under the system outlined a splendid plant ledger may be maintained with a minimum of labor, the benefits of which will be realized more and more as time goes on. The asset figure shown on the balance-sheet will no longer represent a shell concealing an atrophied clam; the depreciation reserve will not tend to depart from facts in geometric progression; the disappearance of assets may be discovered systematically; disputes with revenue agents as to amount of depreciation, date of acquisition and cost of assets and amount of final loss or profit will cease, and order will be found where chaos existed before.
Accounting for Irrigation Companies

BY CHARLES D. TURNER

The irrigation of arid and semi-arid lands has been the means of reclaiming for the benefit of humanity many acres of otherwise more or less worthless land.

The question of the average increased value of irrigated lands over lands not irrigated, from the viewpoint of their productivity, is a subject upon which there are differences of opinion. Statistics furnish us with the information that where lands are irrigated, that is to say moisture is thus regulated, they will produce one third more on an average than lands which depend upon the uncertain rainfall. There is no reason to doubt that over a given number of years, the more the better, statistics on this subject are approximately correct. Thus we might say to the farmer that if he will keep his profit-and-loss statements on twenty- or thirty-year bases the statistics we have will apply, but for any given year we have very little to offer in the way of advance information.

It is to be assumed naturally that irrigation facilities are not placed on lands where the average rainfall is sufficient. This being the case there is in irrigated sections less likelihood of an amount of rainfall at any time that would be damaging to crops, although this very thing may occur and sometimes does. It is not an uncommon thing for a farmer to irrigate his land in expectation of a dry spell and then receive in a few days a heavy rain, which is generally more damaging to crops than is a drought. Such factors work a hardship in evolving dependable statistics.

Most of the water used in the United States for irrigation purposes is derived from streams, and as streams rise and fall a dependable supply of water is not always available in the stream itself. For this reason waters from the streams are impounded and stored in reservoirs for future use.

The contour of the land and the number of acres to be watered will govern the nature and extent of the construction of the plant and facilities. As a rule there will be at least two levels or benches for which pumping plants will be constructed to raise the water to a height where it will flow downhill, as it were. The main canals and laterals which are constructed by earth fill or dredge may flow through tunnels in hills or around them, if more economical, or
over low areas such as lake beds, when aqueducts will be constructed. It might be mentioned here that the irrigation company is concerned with the maintenance and operation of all avenues through which the water travels except the so-called field ditches which are constructed and maintained by the farmers on their lands.

The first lift-pumping plant site is generally selected at a point where there is the least danger of the bank of the stream sloughing off at high stages. It is generally necessary to do some dredging at this point each year in order to provide a more or less constant source of water supply, and in some years this forms an item of expense of considerable proportions, especially in years when the stream reaches the flood stage. The matter of setting up a reserve in the accounts for this contingency is good policy but not often observed.

In sections where streams overflow periodically and where there are no flood control drains or levees the necessity arises for consideration of a reserve for damage from this source. An amount should be accumulated through an annual charge to a profit-and-loss account based in amount upon past experiences as to the extent and frequency of this loss. When the reserve has reached reasonable proportions no further credits should be made to it. It may be submitted that there are companies who observe in the accounts the charging off of damage from overflows in subsequent years on the theory that the uncertainty of the extent of the loss does not offer sufficient information for the setting up of an amount that might be indicative of the requirements. This, however, is not a good argument against setting up some sort of an estimate which would at least be an acknowledgment of the danger of overflow damage.

There are three common forms of organization of irrigation companies, viz, the private corporation, the mutual corporation and the irrigation district.

The private corporation is generally operated by land companies owning large tracts of land and the irrigation facilities are for the purpose of making the land salable. These companies rarely operate with profits as an object and as a general rule when the land is sold the irrigation facilities are conveyed to the owners of the land.

The so-called mutual corporation is organized with an amount of capital stock equal to the cost of constructing the plant and
facilities, the par value based upon the pro rata cost of the construction per acre, so that the number of shares will equal the number of acres in the system. Under this form of organization deeds to land include title to the stock and for this reason the stock in itself has no value.

The irrigation district or water-improvement district which is created by statute is a political subdivision of the state in which it exists. Under this form of organization bonds are issued upon vote of property owners in the district to provide funds for the purchase of the plant and facilities. Ad valorem taxes are assessed and collected to cover the interest and sinking-fund requirements of the bonds. The balance-sheet of the irrigation district should be divided so as to show separately the capital section and the operating section.

The irrigation district furnishes a means of obtaining a plant from money borrowed through bond issues which as a rule can be sold with a lower rate of interest than bonds which do not have the same security. On the other hand it is a matter of going into debt at the outset for the entire cost of the plant, and the expense of renting money adds indirectly to the cost of the plant. In the interests of good business there should be a considerable amount of argument in favor of the plan of organizing a mutual corporation in place of the irrigation district. It is shown by statistics on the subject that the mutual corporation prevails in more than one half of the irrigation projects in the United States, exclusive of the projects sponsored by the United States reclamation service.

REVENUES

Irrigation companies are required to anticipate their revenue requirements and to fix assessments at the beginning of the year. Each acre is assessed with a flat charge and in addition a fixed amount is determined as a charge for a unit of water used by the farmer. The method used by the company for measuring the water is immaterial. A company may use meters when the charge is to be made on the basis of gallons consumed, but the most prevalent method is that of turning the water on the farms and allowing the farmer to take the amount he deems necessary for an irrigation of his land, and in this event the unit of measurement would be the number of acres thus watered.

It is necessary to assess each acre with a flat charge annually inasmuch as there is no way of estimating at the beginning of the
year how much revenue will come from the sale of water. The rate is fixed with the intent of being equitable in so far as the owners of the land are concerned and sufficient in so far as the company is concerned. It is, however, a difficult matter to determine a flat rate and a rate for a unit of water consumed so that they will work out to the satisfaction of all customers. It happens that large tracts of land may be idle for one or more years and during this time no revenue comes to the company from the sale of water, so it must depend upon the revenue from the flat charge only in such cases.

It is a good plan for companies to request consumers to advise them of the crops they expect to plant during the season. This furnishes an indication of future demands for water although, of course, it lacks information as to rainfall and therefore can not be relied on completely. While there is a certain amount of regularity in seasonal rainfall, in certain sections Jupiter Pluvius still has full control of the faucet and provides what the “native” is apt to term “an unusual condition for this time of the year” quite often, in fact often enough to upset the majority of estimates. As a matter of fact the success of irrigation companies and farmers in irrigated sections depends each year upon the opportune arrival of rain.

The revenue from charges against each acre of land together with the revenue from sales of water furnishes the bulk of the operating revenue of the company. As previously said, it is intended that these rates will bring a total revenue equal to the total expense and also will be divided as to equity among all concerned, but the difficulty of estimating the revenues to be collected and the expenses to be incurred results in providing each year a surplus or a deficit of some proportions which must be taken into consideration in fixing the rates for the succeeding year. When a company has been in existence a number of years, however, and the land under irrigation is being more or less completely farmed the difficulty of fixing the water rates is greatly minimized.

Often an irrigation company will sell water rights to lands lying adjacent to it and take them into the system. In cases where this is done there may be a different viewpoint as to the accounting elements entering into the sale. The water right may be sold on a basis of the par value of the stock plus an amount based upon the accrued flat rates that would have been paid had the land been
in the system since the organization of the company. This is provided that the company has been in existence for only a few years and that the figure is within reason for the purchaser according to the value of the water right. In this instance there is a specific application of the excess over par paid for the stock indicated and the profit may be considered as an operating profit. If the company is an old one an amount may be paid equal to the enhanced value of the land, which would include an amount, say, of thirty-five dollars an acre as representing the cost of the plant, the residue being credited to profits in the year in which the sale is made. However, profits obtained from the sale of water rights in such a case are in the nature of profits from the sale of capital assets and are not operating profits except possibly in so far as they represent flat rates of the current year.

It is necessary, where all the stock of a mutual corporation has been sold previously, to amend the charter of the company when taking in new territory by selling water rights to it.

Where lands are taken in and water rights sold by the irrigation district the procedure is very much the same as with a city or town which annexes additional territory, except that in the case of new territory coming into an irrigation district the owners thereof are required to pay a premium for the privilege in addition to being subjected to an ad valorem tax and assessments for the operation and maintenance of the company. Any excess received by the irrigation district in the sale of a water right over cost of providing the additional facilities is considered as profit from the sale of capital assets.

Obviously there is a limit to the extent to which an irrigation company, and more especially an irrigation district, may go in selling water rights, and it can be assumed that only in territories which have been recently reclaimed by irrigation is much of this done.

Methods of handling the construction of canals and appurtenances on lands taken into systems differ. There is a tendency to allow the purchaser to build the works under the supervision of the irrigation company's engineers and to require that a certain standard as to size and quality be maintained in all construction. Where this is done it is necessary to place a value on the construction to set up on the books of the irrigation company, as the actual cost to the purchaser might not represent the fair value and it is not always obtainable from the purchaser.
Other sources of revenue of the irrigation company are water sold to cities or towns, usually on a basis of gallons pumped into reservoirs; fees received by the company for running contours of farms, and interest which is assessed against delinquent flat rates.

EXPENSES

The following operating and maintenance accounts with amplifications are typical of irrigation companies operating two lifts:

<table>
<thead>
<tr>
<th>Operating expenses:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canals:</td>
</tr>
<tr>
<td>First lift-pumping plant:</td>
</tr>
<tr>
<td>Labor: $...........</td>
</tr>
<tr>
<td>Fuel: $...........</td>
</tr>
<tr>
<td>Lubricants: $...........</td>
</tr>
<tr>
<td>Supplies: $...........</td>
</tr>
<tr>
<td>Second lift-pumping plant:</td>
</tr>
<tr>
<td>Labor: $...........</td>
</tr>
<tr>
<td>Fuel: $...........</td>
</tr>
<tr>
<td>Lubricants: $...........</td>
</tr>
<tr>
<td>Supplies: $...........</td>
</tr>
</tbody>
</table>

Cost per acre irrigated

<table>
<thead>
<tr>
<th>Maintenance expenses:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canals:</td>
</tr>
<tr>
<td>Repairs—ordinary wear and tear $...........</td>
</tr>
<tr>
<td>Repairs—due to breaks $...........</td>
</tr>
<tr>
<td>Cutting weeds and dredging $...........</td>
</tr>
<tr>
<td>Canal structures:</td>
</tr>
<tr>
<td>Bridges and culverts $...........</td>
</tr>
<tr>
<td>Siphons and flumes $...........</td>
</tr>
<tr>
<td>Miscellaneous $...........</td>
</tr>
<tr>
<td>Reservoirs: $...........</td>
</tr>
<tr>
<td>First lift-pumping plant:</td>
</tr>
<tr>
<td>Repairs—ordinary wear and tear $...........</td>
</tr>
<tr>
<td>Bank protection and channel $...........</td>
</tr>
<tr>
<td>Second lift-pumping plant:</td>
</tr>
<tr>
<td>$...........</td>
</tr>
<tr>
<td>Buildings $...........</td>
</tr>
<tr>
<td>Equipment $...........</td>
</tr>
<tr>
<td>General $...........</td>
</tr>
</tbody>
</table>

Cost per acre under canals

Water enters the canals through the pumps at the first lift-pumping plant and is conveyed through a main canal direct to the
second lift plant where it is raised to another and higher lift whence it enters the second lift main canal. Laterals lead out from the main canals and sub-laterals from them, and finally the so-called field ditches carry the water over the land to be irrigated.

Gates and checks are used for diverting and holding the water. These are generally of concrete and metal construction. The water is delivered to the land to be irrigated under the personal supervision of a representative of the company.

Farmers desiring water for irrigation purposes are required to make application and to pay for it in advance. It is delivered when enough applications are in the hands of the company to justify it in the interests of economy and efficiency. While there may be a considerable diversity of crops planted and while certain crops will need more water than others, cooperation on the part of the farmers generally brings about a request on the part of enough farmers in one section to justify the company in diverting water there at times when it will be beneficial to all.

During periods when pumping plants are not in operation, which are at times when because of rainfall there are no demands upon the company, the employees make necessary repairs and a certain amount of their time is non-productive. The payroll should show a distribution as between maintenance, operations and non-productive activity. Salaries of employees who supervise the delivery of the water to the farms should be charged to operating expenses of canals. The cutting of weeds which grow up in the canals and the work of removing silt which in time forms an obstruction are charged to maintenance.

Over periods of time some fairly dependable information may be obtained as to the cost to irrigate an acre of land one time by dividing the costs of operating for the year by the number of acres watered during the year. The cost of maintenance likewise may be obtained by dividing the total cost of maintenance by the number of acres maintained during the year.

The operating cost of delivering water to an acre of land, found in this manner, is a basis for making the rate for the sale of water per acre, and the cost per acre of maintenance and overhead is a basis for making the fixed annual flat rate. However, in making a division between the two rates consideration must be given to the fact that the annual flat rate will produce a certain and de-
terminable amount of revenue while the revenue to be received from the sale of water will depend upon occurrences over which the company has no control. For this reason a certain sum is usually added to the flat rate and taken from the charge for delivering water, as determined upon the basis mentioned above, in an attempt to make the rates equitable.

The irrigation district assesses the ad valorem tax against gross acreages, that is to say the entire acreage owned by the taxpayer, while the annual flat rate is assessed against the net acreages which exclude lands occupied by field ditches, roads or lands too high or too low or for other reasons not subject to irrigation. For these reasons records must be kept of both the gross and net acreages in each tract.

It is found where changes are often being made in net acreages and where sales and transfers of land occur frequently that the ordinary loose-leaf ledger containing an account with each piece of land in lot and block order and supported by a cross index as to ownership in alphabetical order is best suited to the work of accounting for this form of accounts receivable. The map of the district should be checked against this ledger to ascertain that all lands in the district are being properly assessed.

The statutes of states where irrigation districts exist usually prescribe that the familiar tax roll must be kept with ad valorem taxes. From this roll, at the close of the year, the delinquent taxes are written upon the delinquent tax roll, errors are corrected, etc., and the roll of persons from whom the tax collector has collected taxes for the current year is set aside in the files. This procedure requires the writing of a great deal of information each year, while if the data were carried in a loose-leaf ledger they would need to be written only once, except in the few instances where changes might be necessitated by the division of tracts of land. Where the accounts are kept with the land in place of the owner a change in ownership would require only that the cross index be adjusted accordingly.

The writer knows of one irrigation district which has found it advantageous to keep the tax roll as prescribed by statute as a matter of legal requirement and at the same time keep the same information in a loose-leaf ledger.

There are some companies which have found the system of selling coupons good for one acre of irrigation to be more satisfactory than the system of requiring a deposit covering the number of
Acres to be watered. The latter method calls for a little more accounting work than the former, but in my experience has been more popular with water users.

All receipts from the sale of water are credited in the cashbook to deferred revenue from water sales. Reports of water delivered made daily by the canal supervisors furnish the information for the compilation of a monthly journal entry debiting this account and crediting revenue from water sales.

One-twelfth of the annual flat rate assessed in advance is transferred monthly from deferred revenue from flat rates to revenue from flat rates.

Some companies include in the annual fixed flat charge one irrigation of the land and where this is done it should be stipulated that the water must be taken within the year, which would provide that the unearned-revenue account with these water sales would be wiped out within the year and the company would not be required to carry the obligation over into future years.

As the charge for water to be delivered is paid in advance and as it often happens that water users do not take all water they have paid for in advance, the auditor should verify the unearned revenue from water sales by the file of unfilled water orders.

There is no necessity for keeping an accounts-receivable account with a customer for water sales, as each sale is a cash transaction.

It is the writer's opinion that in furnishing to a client the information set forth in the balance-sheet and the profit-and-loss statement there should be sufficient explanation to make each account clear to the uninformed reader. In the instance of what has been set up in the books as deferred or unearned revenue from water sales it should be added that this amount is also refundable and, therefore, at the date of the balance-sheet, is a demand upon the working capital of the company. Without this information there would be reason to suspect that the company had a margin of profit in the unearned revenue.

With irrigation companies the statement of resources acquired and their application is a very acceptable addition to the usual forms furnished by the auditor. It is the writer's opinion that this statement should do more than show the fluctuations of the working capital during the year in condensed form. It should show, in the case of notes payable, for instance, important items paid and important new loans made and other information that may be buried in the accounts.
I have found also that irrigation companies like to obtain in the auditor's report an analysis of the cash transactions of the year as compared with the accruals, and the records should be kept in such a way that this information will not be difficult to obtain.

In conclusion, I might add that accounting for irrigation companies offers nothing new to the accountant. The procedure would be basically the same with a company selling some commodity other than water. As a rule the directors of the irrigation company are farmers not very familiar with accounting terms, and therefore technical terminology must be set aside to some degree and language used that will be clear to those who are not by any means accountants. I do not mean by this that our terminology is not exact as far as it goes, but in our effort to be brief, which we sometimes regard as being efficient, we occasionally fail after a fashion to carry out our mission as reporters of the whole truth.
Depreciation and Appreciation of Fixed Assets *

BY CHARLES E. MATHER

In view of the rapid advancement in all branches of research, it behooves one, in presenting a case, to beware lest his information and opinions be incomplete on the one hand, or, if complete as far as they go, lest on the other hand they have already become obsolete. Mindful of these limitations, I submit the following thoughts as a basis for discussion on the subject of depreciation and appreciation of fixed assets.

My boyhood days were spent in a town where there exists an old circular building, still in use for its original purpose. Had accountants applied the principle of depreciation at as low a rate as one half of one per cent. the cost would have been written off long before the birth of Columbus. The building is known as the Church of the Holy Sepulchre and is one of five similar churches built by the crusaders, four of which are still in use.

Many other similar examples could be cited; nevertheless, these are exceptions that prove the rule and we may say, broadly speaking, that all material things, the product of man’s labor, must be regarded as coming to an end of their useful life within a very much shorter period.

Land, however, is not subject to the same rules; its value seems to be dependent not at all on time but upon the migrations of members of the human race, and therefore its value may accordingly go either up or down.

If the original cost of an asset used for profit is not recovered by the time that it becomes valueless, it is clear that a loss has resulted. Any actual profit made must be over and above the original cost spread over the life of the asset. This much, at least, is self-evident.

In looking over some old papers recently, I found a paper on “Depreciation in relation to the audit of accounts” read before the Manchester Institute of Accountants in January, 1876, more than fifty years ago, by my father, John Mather, a public accountant without any letters to his name at that time—no qualifying titles were then in use, except in Scotland. From this I shall quote later, but I recall with some interest that although an expert on depreciation in theory, as far as my memory goes, the

* Address delivered at a meeting of the Society of Certified Public Accountants of the State of New Jersey.
writer of that paper never recognized in his own life the actual fact of depreciation but attributed any breakage or wear and tear in furniture or clothing of his own household to gross carelessness or inexcusable negligence—something, in fact, that ought never to have happened. However, it is the duty of accountants to recognize as a fact the limited life of whatever is employed for profit and to reflect that fact in the accounts with which they deal.

Of course, the actual length of life is, and must be, a guess, but past experience is a good guide in making an estimate. By means of this guide we fix upon a given life and a given scrap or residual value and spread the difference between such value and the original cost over the term accepted as being the life of the article. Many intricate calculations may be used, but for practical purposes a straight-line method seems to serve the ends admirably; that is to say, a charge of an equal amount per annum over the whole life. It is possible and perhaps conservative to disregard the scrap value and divide the entire cost over the period, leaving the scrap value as a little leeway or something to the good.

In the paper to which reference has been made I find some suggestions offered as to rates that may be applied which do not seem altogether unreasonable even today, namely,

<table>
<thead>
<tr>
<th></th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Boilers</td>
<td>10% per annum</td>
</tr>
<tr>
<td>Fixtures</td>
<td>5%</td>
</tr>
<tr>
<td>General machinery</td>
<td>2½%</td>
</tr>
<tr>
<td>Buildings (brick or stone)</td>
<td>2½%</td>
</tr>
</tbody>
</table>

Some twenty or more years ago some leading accountants referred generally to depreciation as "accruing renewals." This term appeals to me as describing the case fairly accurately except for one thing—that is, the looming fear of obsolescence. This, if it is to be provided against, requires a reserve of something beyond the regular wear and tear year by year.

But this term "accruing renewals" brings up another question: whether provision is to be made merely to keep intact, or restore, the original capital outlay, or to provide for the possibly higher cost of renewal when need arises. It may be argued that strictly accounting principles are met by providing for a restoration of the original outlay and when that is provided, anything over and above is, in fact, profit, even though at the end of the term the owners are left with their original capital in the bank and the worthless plant that would require twice that sum to replace it.
Depreciation and Appreciation of Fixed Assets

Such a result would probably bring forth from the owners a protest that they did not care for strict accounting—what they wanted was to know where they stood and they had no idea that their business was about to come to an end. Prudence, therefore, would dictate that the observance of such principles, even if strictly correct, is not sufficient, and that provision should be made for such a contingency as the one suggested above. Indeed, in the case of a pending sale, or bond issue, based upon a current valuation, profits stated after depreciation based on cost would be very misleading if taken as a guide to future results.

Whichever view is accepted, the thought underlying the expression "accruing renewals" brings me to my favorite heresy. Until a month ago I believed myself to be in the minority of one with regard thereto, but in a widely circulated publication issued by a prominent manufacturing concern, I find in the September, 1927, issue an article entitled "Principles of depreciation," in which this very heretical theory is discussed; but it is dismissed with this comment, "however, this method is not to be recommended without discrimination, for being based more on estimates (than other methods discussed) it ought to be put into practice only where the experience of the past furnishes a reliable barometer for the future."

What are renewals in this sense? When provision is made for an expense, the amount of which is known, such, for instance, as taxes, we know exactly how much to provide as a minimum, and when the payment is made we know exactly that it either is or is not part of the expense for which provision has been made. But where can we draw the line between what are actual renewals or replacements and what are repairs?

By way of illustration, an engine may require a new pump, new piston or new valve or anything else. If the engine is a unit these are generally treated as repairs; if a pump is a unit (whether it is working by itself or as part of an engine), a new pump would be a replacement and a new valve would probably rank as a repair. If a valve were regarded as a unit a new valve would be a replacement and so on down the line to the smallest unit. But anything that forms only part of a unit when broken or worn is replaced and charged as a repair. Or, to express the thought from the other viewpoint, expenditures treated as repairs recognize the part replaced as only an incidental part of a unit; expenditures charged against the reserve recognize the part replaced as a unit. Is there
any logical distinction? Is it not, after all, a question that is
decided by the size, importance or more commonly the amount in
dollars and cents of the work involved? Perhaps in relation to
our own personal affairs we may consider that we “repair” our
shoes with the new sole and heel, but do we not “replace” a
broken lace? With the above in view is it not necessary, in de-
termining the rate of depreciation, to consider the amounts which
are being spent year by year for repairs, so called? Is it not true
that if little is spent the period of final renewal is approaching
more rapidly and when heavy repair work has been carried out is
not the renewal indefinitely postponed, or has it not, in fact, been
partly executed?

I was called upon recently to fix a rate of depreciation for the
purpose of an annual statement. In doing so I inquired very
closely into the amount that had been expended for repairs out of
revenue, and finally determined upon 4 per cent. in the main with
a higher rate for specific items, as appeared to me to be necessary.
A little later when this rate was accepted I was asked to express
my views as to what was an adequate depreciation for the last
twelve years and I reflected that had I originally required some-
thing like 10 per cent., this latter request might have placed me in
an embarrassing position.

Coming to the point, my contribution to the discussion of this
subject is: Have we not gained sufficient experience to give us a
composite rate or rates, applicable to varying depreciating assets,
sufficient to cover the extinguishment of the original cost, together
with incidental repairs and partial renewals during the life of the
asset? If we can determine such a rate this would provide a
uniform charge to the operating account for each year and no
questions would then arise calling for distinction between operat-
ing repairs on the one hand and renewals to come out of the
reserve on the other hand. Alternatively, in lieu of a percentage
on the cost of the item to be depreciated, the charge could be
based on production (with a fixed minimum). It would then
increase as the production increased, to cover the presumably
heavier strain and wear involved.

If we have not enough data to work upon, is it not time for such
data to be collected and filed for the general use of such account-
ants and clients as desire to use it?

A word about appreciation. Increase in the value of an asset
used for operating purposes and not for resale is something entirely
outside the purpose of the business and usually arises from conditions beyond the control of the management. The problem is not new, for the paper by John Mather, previously referred to, contains the following reference to it:

"In the case of the C. D. Colliery, whilst auditing the accounts during the period of enhanced prices already referred to, it was found that the Manager, in perfect good faith, had considerably raised the valuation of the permanent rails underground on the principle that if sold at that time they would realize even more than the price stated. On its being pointed out that his business was to make a profit on coals, not on iron rails, he admitted the argument and made the correction. But here we have, I think, an instance where it is legitimate to suspend the depreciation for the time being, though not to take credit for any enhanced value."

I submit the following for consideration:

(a) Strictly speaking, accounting is what its name implies, being a "count" of what has been done with cash or its equivalent.

(b) Usually appreciation in value is something quite outside the ordinary purpose of the business, and while it may not always be improper to take up appreciation in the accounts, it should always require a special reason and be done with caution.

(c) The amount of appreciation is always an estimate and it is well to limit, as far as possible, the items in a balance-sheet which are subject to estimate.

There is a further consideration, prompted by Robert H. Montgomery in his paper* read at the annual meeting of the American Institute of Accountants, namely, does not the change in conditions of business require a change in the attitude and practice of accountants, including a modification of the strict idea of accounting for cash in dealing with assets? Does it not call (Mr. Montgomery asks in effect) for some expression of values rather than of cost?

This seems to be a point to which accountants must give close consideration in the immediate future. We may, without committing ourselves to any new principle, go as far as to admit that a parenthetical note or explanation as to what is the present market value or appraised value of certain capital assets, whether it be more or less than the book value or the cost, would be of considerable importance in a financial statement and may in certain

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* Accountants' Limitations. See The Journal of Accountancy, October, 1927.
cases even be necessary to a fair presentation of the financial condition of the business.

There are, of course, many points not considered in these remarks, such as how depreciation or appreciation should be considered in a cost-plus contract; whether a rate should be used based upon the original cost or on the appraised value, at the time the contract is made; the same principle with regard to fixing rates for public utilities; the question of whether excess depreciation should be written back, when clearly recognized as excessive; the question whether depreciation should be taken at a flat rate on the whole or at an appropriate rate on each individual item. In my judgment, on the last point, no account of depreciation can be intelligently constructed unless based upon the age and expected life of each individual depreciable item in the plant inventory.

The foregoing remarks will apply, in certain instances, both to tangible and intangible assets, but with regard to intangibles the facts may be more difficult of ascertainment, and caution and common sense must, of course, be exercised.

In conclusion, I would extend a recommendation found in the ancient paper referred to already, namely, that an organized body of accountants such as this act as collector or recipient of data relative to both repair charges and depreciation rates, with a view to facilitating the use of a composite inclusive factor and thereby equalizing the annual burden chargeable against the operations of manufacturing concerns.

* * * *

Note: The writer’s attention has been drawn to an income-tax law of Porto Rico (now repealed) by virtue of which the board made the following regulation, under the caption of depreciation and incidental repairs and replacements:

"Therefore this board resolves that as a general and uniform ruling for . . . industries where machinery is used . . . the following table of rates on the value of all property subject to depreciation which does not include, of course, lands and intangible assets shall be accepted henceforth as general deduction for depreciation and all kinds of repairs whether incidental repairs or replacements."

The table referred to in the regulation was evidently intended to represent the board’s idea of a proper charge to operating for both repairs and depreciation in one amount.

It should be pointed out, however, that most of the machinery to which this applied is used in a seasonal trade, the production of sugar, and is very thoroughly overhauled between seasons.
Depreciation in Public-utility Income Accounts

BY GEORGE SHIRAS CALL

The writer believes that the accountancy profession can render a great service to the public by working for the revision of public-utility income statements and for the adoption of a form of statement that will present all the facts and will in no way tend to mislead the public or to conceal the true state of affairs of the company concerned.

Early in the year 1927 a salesman representing an investment banking house presented a pamphlet describing a security that was said to be "on the bargain counter." The offering in question was the class A common stock of an electric-light and power company and, according to the salesman, the market price of the stock was very low in comparison with the net earnings per share.

The writer looked over the income account of the company for the year 1926 and inquired whether the net earnings as shown were before or after depreciation. It developed that depreciation had not been deducted in arriving at net earnings and the salesman had no data concerning the depreciation allowance for the year. He was asked why depreciation was not taken off before the net earnings were shown and the answer was, "Well, you see, that goes back into the property." Just how the depreciation allowance goes back into the property was something that the salesman could not explain satisfactorily, as his idea of the methods and procedure of calculating and recording depreciation was somewhat hazy. After some discussion the writer continued to hold his former opinion that the depreciation allowance represented the amount that comes out of the property rather than something which goes back into it.

The income account of the company mentioned above for the year 1926 was substantially as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross earnings</td>
<td>$2,400,000.00</td>
</tr>
<tr>
<td>Operating expenses, maintenance and taxes</td>
<td>1,330,000.00</td>
</tr>
<tr>
<td>Net earnings</td>
<td>1,070,000.00</td>
</tr>
<tr>
<td>Interest</td>
<td>415,000.00</td>
</tr>
<tr>
<td>Preferred dividends</td>
<td>260,000.00</td>
</tr>
<tr>
<td>Balance</td>
<td>$395,000.00</td>
</tr>
</tbody>
</table>
After deduction from the balance of net earnings shown of $144,000 for depreciation, representing 6 per cent. of the gross earnings, the remainder came to $251,000 or $2.28 a share of common stock, in comparison with a figure of about $3.60 a share before depreciation. The percentage of 6 per cent. probably represents a fair deduction for depreciation for the average electric-light and power company, inasmuch as it is usually considered that an allowance of from 12 per cent. to 15 per cent. of gross earnings should be made for total maintenance and depreciation, and the maintenance charges alone should be approximately 7 per cent. or 8 per cent. of gross. A smaller provision should be made in the case of a water company, and a street-railway system would require a larger allowance.

A short time after the salesman's visit there was received from the same investment house a circular recommending the same class A stock and comparing it with the common stock of half a dozen other public utilities. The table showing the seven stocks under comparison included data as to the market price and the ratio of market price to earnings per share. The class A stock recommended was shown to have earnings of $3.60 for the year 1926 and the ratio of its market price to earnings was 7.3. These figures, the writer knew from previous calculations, were based on the net earnings before depreciation, although the circular contained no information on that point.

The earnings per share given for the other six common stocks were the amounts applicable after depreciation, and the group average showed a ratio of market price to earnings of 11.6. Apparently the stock recommended was indeed a bargain, for the circular contained no information to make the casual reader aware that the different bases used for the class A stock and for the other six made the comparisons not only valueless but utterly misleading. It is hard to believe that the statisticians who compiled the circular could have been ignorant of the flaws in their bases of comparison.

A few months ago one of the popular financial magazines contained a list of estimated earnings per share of common stock of a number of public utilities. In this list also two different bases of comparison were used—some of the earnings shown were before depreciation and others after the deduction of that charge.

During the year 1927 the writer has clipped at random from the daily papers of various dates twenty-two advertisements of
preferred stock or bonds of public-utility companies. Of these twenty-two, seventeen show net earnings before the deduction of depreciation; of the remaining five advertisements four show net earnings after the deduction of a fixed percentage for depreciation for which provision was made in the bond indenture or trust indenture, and only one shows the net after the depreciation charges recorded by the company itself.

No attempt was made to obtain a complete file of advertisements of utility securities, but the twenty-two that were studied probably are representative of the general average in terminology and arrangement. It is interesting to note the forms of income accounts and the diversity in terms. What the writer prefers to call "operating revenues" are also variously named "gross revenues", "gross earnings" and even "gross income." From the operating revenues are deducted operating expenses, maintenance and taxes other than federal income taxes, and the remainder is frequently called "net earnings." Sometimes the more explicit term "net earnings available for interest, depreciation and dividends" is used and in other advertisements the word "balance" alone appears. Then, in the case of a bond issue, the annual interest requirements are shown and the public is informed that earnings are more than 2½ times the interest requirements, or whatever the ratio may be. At this point the word "depreciation" drops out of sight, never to reappear—except in the surplus accounts of the various companies.

The depreciation allowances must evidently be charged to operating expense, or else treated as appropriations of net income or of surplus, and this brings us to the question, what is a surplus charge? It is usually considered that a charge to surplus should be made only to cover some cost or expense of a prior year for which provision has not been made during the proper period, or else for some extraordinary expense or loss that is in no way related to the usual business of the company concerned. In the case of public-utility companies it has been a common practice to treat the yearly allowances for depreciation as surplus charges, although it can hardly be maintained that these charges represent some extraordinary expense or loss. The usual argument given for treating depreciation as a surplus charge is that the determination of the proper amount is exceedingly difficult and can not be estimated with even approximate accuracy. Although that contention is probably true there seems to be no justification for
omitting from operating expenses an item for which, even public-
utility operators admit, provision should be made year after
year. In the accounts of manufacturing companies depreciation
is treated as a proper charge to operating expense as a matter of
course, and why should the depreciation provision of a public
utility be veiled with secrecy and mystery and held out from its
proper place among the operating expenses? That is to say, it is
so treated in the published reports to stockholders and in adver-
sisements of securities, but in rate cases the companies involved
never fail to claim their depreciation allowance “above the line”,
together with the other normal and necessary operating expenses.

The writer does not believe that any one method of calculating
depreciation must be followed slavishly. Among public-utility
operators the theory of the retirement-loss-equalization reserve is
probably the most popular and the writer feels that such a reserve,
if carried at a balance sufficiently large to provide for any retire-
ment losses during the year, will serve just as satisfactorily as a
reserve set up on the straight-line method. Whatever the method
may be, it is certain that some allowance should be made each
year and it is difficult to see the logic of charging to surplus an
item which recurs year after year with regularity. Occasionally,
there may be found public-utility companies that make a practice
of charging surplus account with legal fees and other expenses and
costs of prior periods for which some provision should have been
made by means of accruals. Almost all accountants would
condemn surplus charges of that nature and yet it has become
common practice to prepare statements for clients in which the
depreciation charge is deducted from surplus.

The decrease in the net earnings per share of common stock
after depreciation is deducted is particularly noticeable in the case
of a holding company, as in such a company the margin remaining
for the common stock in proportion to the gross earnings of the
consolidated group is much smaller than in an operating company.
For example, one of the large holding companies reported in its
consolidated income account for the year 1926 net income of
approximately $8,500,000, available for retirement reserve and
dividends on the holding company’s common stock. The provi-
sion for depreciation amounted to about $3,400,000 and, after
deducting this allowance, there remained a balance of only
$5,100,000, available for common-stock dividends and surplus.
In other words, the provision for depreciation was equivalent to
about 40 per cent. of the total amount available for dividends and depreciation, and the net earnings on the common stock came to $4.13 a share after depreciation, as against $6.90 before that deduction.

The average investor knows little of the methods of determining depreciation and of recording the allowances on corporation books. He probably has a vague idea that physical property depreciates in value over a period of years, but he is not sufficiently versed in corporation accounting to understand the significance of depreciation in public-utility income accounts, or to realize that the advertisements showing interest earned two and a half times before depreciation really mean that interest charges may, perhaps, be earned only one and a half times after provision for depreciation is made. Neither does the average holder of common stock of public utilities understand the meaning of the annual reports sent to him. He struggles over the consolidated income account if he is of an inquisitive turn of mind, and, after many trials and considerable mental anguish he calculates that the "net income available for retirement reserve and dividends" amounts to some $6 a share of common stock. This will be a pleasing discovery, perhaps, for he will expect to receive a large portion of the net income in the form of dividends over a period of years—50 per cent. to 75 per cent., let us say. But, unfortunately, he has not discovered the whole truth. Concealed in the surplus account there is a "provision for retirements." Whether it is placed in the income account or the surplus account is not a matter of great importance from the point of view of dividends. If included in operating expenses it will reduce the earnings on the common stock from $6 to less than $4, perhaps. If included in surplus it will diminish the amount available for dividends just as effectively. In other words the "poison" is still there, although the sugar coating applied by the immersion in surplus account may conceal it for the time being.

To sum up the situation, it is certain that, no matter what the intent of the bankers may be, the usual form of income account used for advertisements of public-utility securities is misleading. Many securities have been sold on the strength of the "before depreciation" form of statement that would have had scant appeal to buyers if all the facts had been presented. It is dangerous practice to bolster up weak securities by means of statements that tell the truth but not the whole truth.
Accountants are not, of course, responsible for the statements prepared by bankers, yet the name of the accountants shown in a bond circular or advertisement suggests to the public that the income statement was prepared and certified by the accountants themselves.
EDITORIAL

Contingent Liability for Repurchase Contracts

Several readers of The Journal of Accountancy have drawn attention to what they believe to be heresy in an article which appeared in the February issue of this magazine. The offending paragraphs occur in a discussion of instalment financing contributed by C. A. H. Narlian. After considering the effect of the repurchase agreement which is becoming a common clause in financing companies' practice, particularly those which have to do with the purchase of motor cars, Mr. Narlian said:

"The principal factor in an agreement of this kind may be said to place upon the dealer the obligation to accept delivery of repossessions made by the finance company resulting from the purchaser's failure to meet his instalments and thereupon to reimburse the finance company for the unpaid balance. Under this plan, the finance company is called upon to repossess the car and to deliver it to the dealer, and in the event of a material collision damage, the agreement usually obligates the finance company to make due allowance therefor to the dealer.

"Legal opinions rendered by the highest authorities agree that under the repurchase-agreement plan, it is unnecessary for the dealer's balance-sheet to show any contingent liability, and this principle appears to be fully accepted by the banks."

Our readers who have criticized the statements made by Mr. Narlian seem to have overlooked the fact that he does not speak at all of accounting opinions. The address from which these paragraphs were taken was delivered at a meeting of the New York State Society of Certified Public Accountants. Mr. Narlian no doubt fully understood that his audience was competent to decide the accounting question involved; consequently, he referred solely to matters of law and banking practice. Indeed, the omission of reference to accounting opinion is quite noticeable. There is, however, this much to be said in support of the critics: the author might have added that legal opinions have nothing whatever to do with the case. It is wholly a question of what is or what is not proper accounting procedure; and there does not
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seem to be any valid reason to believe that accountants as a whole would subscribe to the theory that a repurchase clause is not a contingent liability of such importance as to merit inclusion in a balance-sheet. We believe that the great preponderance of opinion would incline to the theory that a contingent liability of anything more than insignificant magnitude must be shown, whatever the degree of contingency may be.

Accounting Opinion is Firm

To support this assertion of the attitude of accountants, it is interesting to quote from certain opinions which are soon to be published in a bulletin now in course of preparation by the bureau of information of the American Institute of Accountants. This bureau, as most of our readers know, is a clearing house of question and answer upon accounting principles. The questions asked are placed before several competent authorities for reply and the answers are then sent to the accountant or the firm that inquires. In the correspondence which is now before us, we find a question relative to the treatment of the contingent liability in the case of accounts receivable sold subject to a repurchase plan. This is on all fours with the question arising in the case of a repurchase clause in finance-company contracts. The inquiry was sent to a number of prominent accounting firms and in order to support our contention that the contingency should be shown, we quote the following extracts from replies received:

1. “One fact in connection with the business under consideration which appears to be essential to a true understanding of its financial position is that its bankers hold large amounts of accounts receivable which it may be required to repurchase for cash in case debtors default. Another fact of importance to one seeking to know the financial status of the business is that experience in the past has been that losses in connection with such 'repurchases' have been negligible.

"The client apparently urges that the second fact be offset against the first and that both be eliminated from the accountant's report. From the information given it does not appear that such an offset can properly be made.

"On the other hand, we feel that it is important that both of the facts mentioned be definitely presented, because both of them would be of practical informative value to anyone who may study the statement.

"Going a little beyond the scope of the question, it seems to us that the client should logically be entirely satisfied to have the statement presented with both of these facts included, because it would seem that any unfavorable impression which might be made by admitting the amount of contingent liabilities would be more than overcome by the fact that losses in connection with such liabilities had been negligible in the past, and by the effect of the desire to present the 'whole picture' which desire would be evidenced by including these facts in the certificate or in the statement.”
2. "It seems that your interrogator might well have directed his client’s attention to the provisions in this connection contained in the pamphlet, *Approved Methods for the Preparation of Balance-sheet Statements*, published in the *Federal Reserve Bulletin* for April, 1917. They are as follows:

"Contingent liabilities."—’It is not enough that a balance sheet shows what must be paid; it should set forth with as much particularity as possible what may have to be paid. It is the duty of an auditor who makes a balance sheet audit to discover and report upon liabilities of every description, not only liquidated debts but possible debts. The following are the usual forms under which contingent liabilities will be found:

Indorsements
Guaranties
Unfilled contracts
"Notes receivable."—’When notes receivable are discounted by banks the company has a liability therefor which should appear on the balance sheet. Lists of discounted notes not matured at the date of the audit should be obtained from the banks as verification and their totals entered under 20a, if the cash therefor is shown as an asset.’

"Accounts receivable."—’Inquiry must be made as to whether any of the accounts receivable have been hypothecated or assigned and the sum total of accounts so listed entered under 20b.

The above references to ‘20a’ and ’20b’ refer to sub-classifications shown under the main classification of secured liabilities which appears on the liability side of the form of balance-sheet contained in the *Federal Reserve Bulletin*. Those sub-classifications are as follows:

‘20a—Notes receivable discounted or sold with indorsement or guaranty (contra).’

‘20b—Customers' accounts discounted or assigned (contra).’

‘20c—Obligations secured by liens on inventories.’

‘20d—Obligations secured by securities deposited as collateral.’

‘Whether obligations for the repurchase of instalment notes and accounts receivable are shown as direct liabilities in the manner required by the above quotations from the *Federal Reserve Bulletin*, or are shown as contingent liabilities in foot-notes to the balance-sheet, is a matter to be governed largely by the client’s preference; the important matter being, of course, that the balance sheet discloses the existence of the obligations.

"The fact that losses experienced by the company in repurchasing instalment accounts during the past few years have been negligible is quite irrelevant to the question of the necessity of disclosing the existence of the obligation to repurchase the unpaid accounts."

3. "We have on more than one occasion insisted upon mentioning in balance-sheets the fact that the concern had disposed of instalment paper subject to a repurchase agreement. We believe that in most cases these so-called repurchase agreements call for the finance company's repossessing the merchandise and selling the merchandise to the business concern for the amount outstanding on the paper. Accordingly, it is maintained by some finance companies—and perhaps some accountants and bankers—that the position of the business concern with respect to its obligation to repurchase the merchandise is precisely the same as it is with respect to any other commitments for the purchase of merchandise, which, admittedly, do not have to be recognized in the balance-sheet. Notwithstanding this argument, we believe that any person who is considering the financial condition of the concern is entitled to know that the concern has disposed of its receivables and may have to take some of them back. There is some doubt as to whether this commitment can properly be characterized as a contingent liability, but the fact remains, we think, that it is an important factor in the consideration of financial condition.

"If the repurchase agreement does not call for the repossession of the merchandise by the finance company and the purchase of the repossessed

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merchandise by the business concern from the finance company, but merely calls for a reversal of the transaction whereby the paper was purchased by the finance company; it seems to us that the situation is not essentially different from an assignment with recourse; and, that being the case, there seems to be a definite contingent liability.

"We are very much interested in the statement in the letter that the attitude of the client is supported by several banks. We took the trouble to canvass a number of large banks on this subject, and found that without exception they insisted that information regarding such transactions should be shown in the balance-sheet."

4. "It is our opinion that a balance-sheet should show all liabilities, both actual and contingent. The exact liability which the concern who sold the accounts receivable may be called upon to meet, is difficult of determination. Therefore, we feel that reference thereto, in the form of explanatory memoranda on the face of the balance-sheet, should be sufficient. The important thing is that their existence be disclosed and that such data as will give an idea of the nature, status and amount be clearly set forth. In other words, show the total amount of outstanding accounts sold and the nature of the repurchase agreement. If there has been any experience as to the amount which the concern has been called upon to repurchase in the past, these data might be shown for the information of bankers and others who make use of the balance-sheet."

Other replies were in agreement with the principles enunciated in the foregoing quotations. There was no reply in which the slightest approval was given to the theory that contingent liabilities of this sort, even when most unlikely to become actual liabilities, should not be disclosed. It may be assumed, therefore, that the weight of accounting opinion is entirely in support of the principle that a contingency of any magnitude must be clearly set forth.

Bankers and Lawyers May Not Agree

It will be noted that one of the letters from which we have quoted draws attention to the provision in the pamphlet Approved Methods for the Preparation of Balance-sheet Statements, issued by the federal reserve board, dealing with this problem. There may be some bankers who would look with complaisance upon failure to disclose contingent items if the contingencies were extremely remote, but we do not believe that there are many bankers who would fall in this category. It seems to us that it could be only in extraordinary circumstances that a banker would be willing to accept a statement which did not reveal the true condition with all its possibilities of peril. As has been said, however, the statement made by Mr. Narlian did not make any claim that the views which he expressed were those of the accounting profession. The legal opinion on an accounting matter is not always of great value, for the lawyer is of necessity an advocate and if any purpose could be served by reticence on the
part of a client, the lawyer would naturally seek to find some justification for withholding information which would prejudice unfavorably the opinion of his client's financial stability. This does not infer anything derogatory to the legal profession. The whole question of the respective duties of lawyers and of accountants is thoroughly understood by both the professions. The lawyer is always a special pleader. The accountant should be never. As a matter of fact, it is not true that the contingency in the case of repurchase contracts is always remote. There may be unexpected developments which will throw upon the finance company the positive obligation to repurchase, and if this may happen in small amount it may happen equally well in large amount. The balance-sheet, it is axiomatic to say, is a statement of fact and also of possibilities.

Ownership of Working Papers

Readers of this magazine will remember that last year the supreme judicial court of Massachusetts in the case Ipswich Mills v. William Dillon, et al., decided that the ownership of an accountant’s working papers is vested in the accountant. The case was appealed by counsel for the American Institute of Accountants, and the victory won in the highest court of Massachusetts was of the utmost importance to all accountants and, incidentally, to all clients of accountants. There is, however, a further question which occasionally arises upon which there has not been a legal decision. It concerns the ownership of working papers which were the property of an accountant who died after the conclusion of a case in which he was retained. Such a question was brought to attention a few weeks ago, and the Hon. J. Harry Covington, counsel for the American Institute of Accountants, was asked to express his opinion on the question. He has written the following reply:

"I beg to acknowledge receipt of your letter relating to the matter of working papers which were the property of an accountant now deceased. The question raised by the firm of accountants which has taken over the estate of the deceased accountant is a novel one. Obviously there are no precedents. But I think a careful consideration of the principles underlying the ownership of working papers by an accountant point clearly to a sound solution of the problem.

"In an analysis of the legal situation there must be kept in mind the language of the supreme court of Massachusetts in the Dillon case. In discussing the question of title the court indicated an interest of the client in the papers by the use of three expressions as follows:

(a) 'It may be that these papers contained information confidential in its nature and of importance to the plaintiff.'

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(b) 'The interest of the plaintiff in the information collected and
copied by the defendants and the confidential nature of this information
do not give title to the plaintiff of the defendants' working papers.'
(c) 'Even if it is assumed that the defendants could be enjoined from
the publication of the contents of these papers.'
In other words, while the legal title to working papers was decided to be in
the accountant, the court clearly indicated a doubt that he had any right
either to dispose of them or to make them public.

"Title to property is not necessarily free from limitations, and such must
be the case with an accountant's working papers. If the deceased ac-
countant had retired from business while alive he could not have under-
taken to sell the working papers relating to the business of any client to any
person who succeeded him in practice. And, of course, it is obvious that
the estate of the deceased accountant has no greater right in the working
papers of clients than the deceased had while alive. Certainly, therefore,
his successors cannot obtain any title to working papers from the repre-
sentative of his estate.

"And as there is no liability by the estate for the negligent work of a
deceased accountant there is no use whatever to which the representative
of the estate can put working papers. But assuming that the executor
may have the technical right to retain the working papers during the time
he is administering the estate they would be in a 'dead hand' so to speak,
and when he closes the estate he cannot distribute them to any heir or
representative of the deceased. The confidential nature of the property
would be thus destroyed.

"Having in mind what was said by the Massachusetts court, I conse-
quently have no doubt that in an appropriate legal proceeding (the title of
the accountant to the working papers having become a right without value
or purpose) any court would find no difficulty in expanding the right of a
client to protect the confidential nature of the material in the working
papers into an unrestricted right of possession. Manifestly the accounting
profession should not be on the defendant side of such a possible legal
controversy.

"There is also, it seems to me, a controlling ethical question involved.
The whole theory of the right of the accountant to retain his working
papers against the demand of the client is based upon the proposition that
they represent peculiarly his own work as preliminary to a completed result
which the client has employed him to bring about. And as the integrity
of his work may at any time be called into question, he ought always to be
in possession of the material which demonstrates its accuracy and sound-
ness. After the death of the accountant, as I have already stated, there
can arise no question of liability for negligent performance of service.
As the title is peculiarly in the accountant alone with no right of transfer
inherent in such title the accountancy profession must, it seems to me,
recognize that the interest of the client has been expanded into an imme-
diate right of possession.

"The rule I have just suggested works no hardship to partnerships for of
course the law of partnership gives to surviving partners the interest in
partnership property, and the surviving partners in an accountancy firm
are, of course, continuously liable for the soundness and accuracy of the
work done as a firm matter by a deceased partner. Their right, therefore,
to retain the working papers of a client is unaffected by the death of any
one of the partners.'

No doubt, as counsel affirms, the ethical question involved is one
that would have great weight with any competent court in a de-
cision of ownership in such a case as that cited. The estate of
the accountant would not be affected by adopting the theory ex-
pressed in this opinion and the rights of the client would be pro-
tected. It is very much a question of equity, when all is said and done, and it is upon this broad basis that Judge Covington has founded his conclusions.

Accountants Not Accepted as Registrars The field of the accountant is constantly growing in breadth, and sometimes it seems a little difficult to determine what is the logical and proper boundary beyond which the accountant should not go. The more conservative members of the profession are somewhat perturbed at times by the apparent inclination of clients and others to demand of the accountant a variety of functions for which there is no precedent. There are, of course, other developments to which every accountant would lend his sanction. For example, the appointment of accountants as receivers and trustees in bankruptcy has everything to recommend it and there is no valid argument against it. In California there has recently been an effort to obtain authority for the appointment of certified public accountants as registrars. The matter was brought to the attention of the commissioner of corporations, from whose office we have received the following letter:

*The Journal of Accountancy:*
New York, N. Y.

Sometime ago Mr.——, a certified public accountant of Los Angeles, requested the commissioner of corporations in writing to authorize the appointment of certified public accountants as registrars. Mr.——'s request was made in behalf of members of his profession who had received certificates as accountants.

The commissioner has made a careful study in this matter, the results of which are contained in a letter to Mr.—— under date of December 15th, a copy of which letter is herewith attached.

Briefly, the commissioner's decision is that only trust companies, banks or similar institutions should be approved as registrars in this state.

We believe the commissioner's decision, together with the reasoning upon which it is based, is of so much importance to the accountancy profession, to trust companies and banks, that we are submitting the attached letter to several publications which devote their columns to matters of interest to the profession and institutions affected by the ruling.

If the commissioner's letter or any portion of it is published we would appreciate it very much if we could have a copy of the issue in which the publication appears.

We are also attaching a resumé of our investigation in this matter and which is referred to in the commissioner's letter to Mr.——.

The enclosure to which the commissioner refers expresses the opinion that registrars, in order effectively to protect the holders of securities, should be those qualified to do a trust business under the laws of California or of the United States. The primary and
specific purpose of a registrar, independent from the corporation or its transfer agent is, according to the commissioner, to certify and to guard against an over-issued stock either by the corporation or its transfer agent. The certification of a registrar is accepted practically as a guaranty that the security issued to him is not spurious. The commissioner then goes on to say,

"It is obvious, therefore, that the duties and activities of the registrar in this respect are more than a mere clerical, ministerial and mechanical function. It is quite apparent, therefore, under these circumstances that should the registrar abuse or violate the confidence and trust so reposed in him by the certificate-holder...a definite liability accures. To pursue this reasoning further, it would follow that the certificate holder or the beneficiary would have recourse and redress in law against the registrar. Manifestly, the relation between the parties reflects all the characteristic elements of a voluntary and express trust. The theory that a registrar stands in a fiduciary relationship to both stockholder and corporation is seemingly and substantially supported by the authorities found in the law reports.

"From these premises we believe the conclusion is perhaps permissible that the activities and duties of a registrar, fundamentally and primarily, fall within the broad and general classification of trusts. It equally follows then, assuming that the premise is not altogether fallacious, that those acting as registrars should qualify as such in pursuance to the law of the state made and provided in such cases.

"In the second place, we have made a careful survey of all the leading exchanges and even those exchanges of smaller magnitude in the entire country. We communicated with twenty-six exchanges variously located from the Atlantic to the Pacific and from the most northerly part of the country to the Gulf states and our file discloses that we received twenty-two answers, three failed to reply and one turned out to be something of a trading corporation and not an exchange. Seventeen of the exchanges—and they include the most important and most outstanding in the country—absolutely require a trust company or a bank to act as registrar. Only five, which cannot even be considered minor exchanges, make no distinction in this respect..."

"Third, you no doubt will be able to understand and appreciate the results that might ensue if this department decides to adopt the policy which in effect will single out with approval certified public accountants as registrars, particularly with regard to other professions. We feel that under these circumstances it would be an unjust discrimination against those others who are engaged in other professional endeavors, for instance the legal profession, etc. They, too, like the profession of public accountants, hold licenses from the state. The inference persists that if everyone who holds a license from the state to practise a trade or profession qualifies as a registrar, the field becomes beyond reach, its extremities become vague and its control unwieldy and affords little or no value of the protection that is contemplated by a registrar...."

"Lastly, the department must confine itself to those who apply for and those who operate under a permit from the department and that is the extent of our jurisdiction. Should this department assert itself without warrant in the direction of injecting itself in the management of a corporation by way of supervising and regulating the dealing of the corporation and its beneficiaries other than stockholders and shareholders, the precedent would be dangerous and it would detract in no small measure from the effectiveness of the enforcement of the law that is our charge."
"It is therefore obvious to us, in the light we see it, that the method of having trust companies, banks or those others organized to do a business in this state in conformity with the laws that apply to trust companies, is more practical and is best calculated and designed to give the public the protection that it is entitled to in the regulation of dealing in securities."

So far as we know there has been no attempt in other parts of the country to broaden the scope of accountancy to include the functions of a registrar and it does not seem probable that the opinion rendered by the commissioner of corporations of California will excite any violent opposition in the minds of accountants generally.

Should an Auditor Act as Director? A correspondent asks whether it is proper or not for a professional accountant who is the auditor of a corporation to act simultaneously as a director of the corporation and also whether it is considered proper or improper for an auditor to hold stock in a company while he is professionally engaged as auditor. These are significant questions and it is probable that the opinion of the conservative members of the profession would call for a unanimous "no" to the first and a somewhat qualified "no" to the second. The great principle at issue is, of course, the necessity for absolutely impartial consideration of the company's financial conditions and for frank exposition of the facts whatever may be the effect of such exposure. It is conceivable that an accountant could be found who would be oblivious to his personal interest while exercising his professional function of inquisitor and judge. There are hundreds of accountants who would not let their conclusions be influenced knowingly by the fact of personal interest. But from every point of view it seems eminently desirable that the accountant should be so utterly divorced from financial or other participation in the success or failure of an undertaking under audit that no one could ever point an accusing finger, however unjustly, and allege the possibility of bias. The entirely honest accountants, of whom the overwhelming majority consists, would be unfairly affected by personal interest, because remembering that the imputation of iniquity might arise because of the apparent reason for partiality they would go to the other extreme and become unduly destructive in criticism. It is needless to discuss the accountant, if he exists, who would present a clean bill of health to a sick corporation of which he happened to be a part owner. At the worst he is rare and altogether beyond the pale of
decency. The chief and enduring value of accountancy is not its technical ability to analyze and suggest—it is rather the total impartiality of its practitioners. It seems quite certain, therefore, that in all cases, except some in which unusual conditions exist, the accountant should be neither stockholder, bondholder nor an officer or a director of a corporation to which he accepts appointment as auditor. But the exceptions are worth consideration and there are times when an auditor may be almost compelled to act as director. For example, it happens now and then that a company passing through reorganization or some other form of metamorphosis needs the directing mind of the man who has been its auditor and knows the facts better than anyone else knows them. In such cases there is not the least cause to question the propriety of the accountant if he joins the board of directors and acts as auditor at the same time, but—and here is the vital desideratum—it must always be distinctly understood by security holders and potential investors that the dual relationship prevails. The arrangement must be openly made and openly carried out. Then no one can truthfully say that the auditor is guilty even of unwisdom. He is acting merely at the will of the owners who know all about it.

**Should the Auditor be a Stockholder?**

The possible correctness of acting as director and auditor at the same time does not affect in any way the impropriety of accepting engagement as auditor in a corporation in which one has a substantial interest. It would perhaps be a counsel of perfection to suggest that it would be wrong for an accountant to hold a few shares of stock in a corporation after he had been appointed to make an audit and to report, but there are many accountants who make it an invariable rule to sever any personal interest which they may have when called in to act as auditors. It would be extremely difficult also to determine at what point an interest might be considered substantial. Could an auditor properly hold one hundred shares or two hundred? If not two hundred, might he retain one hundred and one—and so on without ever reaching a decision. When a question of this general sort was before the committee on professional ethics of the American Institute of Accountants some time ago, the chairman expressed himself in emphatic manner. He said:

"The principal value of an accountant's certificate is that it is supposed to be given by a competent, disinterested and impartial party. When an
auditor certifies to the accounts of a company whose policies have been determined to a greater or lesser extent by himself, the certificate would not have much more value than if he were certifying to his own accounts. The benefit of an independent judgment is missing in such a certificate, no matter how honestly and carefully the auditor may have done his work. The same comment would apply in respect to an auditor certifying to the accounts of a company in which he had a substantial investment, as his judgment as an investor could not help but affect his judgment as an auditor, and the benefit of an independent judgment would be lacking.

"I am of the opinion that a disclosure of the dual relation of the auditor to the company should have been made to the bank at the time that his report was submitted, as this would be one of the elements to which the bank officials would have given consideration.

"I would not go so far as to say that it would be improper for an auditor, or his firm, to certify to the accounts of a large corporation in which he happened to own a few shares of stock, but wherever the investment is sufficient to question his disinterestedness, he should not certify to the accounts without a full disclosure of his relation.

"I have been informed of at least one firm of accountants whose partners do not invest in the stock of any company to whose accounts they certify."
Income-tax Department

EDITED BY STEPHEN G. RUSK

The determination of taxable income derived from the operation of a foreign branch by an American corporation is presented in a novel manner in the case of Frederick Vierot and Achelis v. Salt's Textile Manufacturing Company in the United States district court, Connecticut district. The Salt's Textile Manufacturing Company's branch in France earned a profit in the year 1919, if its income was measured in francs without consideration of the depreciation of the value of the francs in terms of United States dollars, but sustained a loss when the depreciation was taken into consideration.

This case presents very interesting features to accountants and we recommend a careful reading of the decision to those whose practice brings them in contact with features of exchange values of money. The court's decision is briefly stated as follows:

"The loss from operations in a foreign country was computed by taking the difference between the net current assets of the foreign branch at the beginning of the year, expressed in terms of United States money, and the net current assets of such branch at the end of the year, expressed in terms of United States money, thus rejecting the government's method of computing the profit in foreign money, and converting such profit into United States money at the close of the year."

This decision seems to open up the somewhat abstruse question of what is income. The receiver's (of the Salt's Textile Manufacturing Company) contention as stated by the court, "involves an exegesis to that part of the statute which attempts to determine income; while that of the government is an attempt to apply the provisions relating to allowable deductions."

It is apparent that the government followed the classic methods of accounting in an endeavor to determine the net income "realized," whereas the receiver interprets net income or loss upon the basis of the decrease of value of assets occurring within the year, a method which, if generally followed, would lead far afield and involve the inclusion in income of unearned increment (a term dear to the hearts of the Henry George cult of economists) or unrealized profits, were there an increase shown by such method, as it would seem to comprehend the element of the fluctuation of value of money as measured by its purchasing power. These comments touch but a few of the considerations that arise from the court's ruling, and we believe the subject matter and the conclusions of this case will be of absorbing interest to all accountants.

Another decision of major importance is that of Justice F. L. Siddons of the supreme court of the District of Columbia in the case of The United States ex rel. James S. McCandless v. The United States Board of Tax Appeals. In this case "a mandamus was issued to compel the board to enter the findings of fact and decision of a division as that of the board in the case of a review by the entire board where the taxpayer was given no opportunity to be heard" (by the entire board) "and where there was no specific action by the chairman directing that this particular decision should be reviewed."

It appears from a reading of the court's decision that the taxpayer's case was heard by a division of the board and that the division sustained the position of
the taxpayer, but he was not notified of the decision of the division. The
decision was later reviewed by the entire board as a matter of consistent policy
of the board but not in conformity with subsection 1 of section 900, which
provides

"A division shall hear and determine appeals filed with the board and
assigned to such division by the chairman. Upon the expiration of thirty
days after a decision by a division, such decision and the findings of fact
made in connection therewith, shall become the final decision and findings
of the board, unless within such period the chairman has directed that such
decision shall be reviewed by the board."

It appears that division No. 3 was assigned to hear the appeal; that it had
such hearing, and that under date of November 26, 1925, sustained the tax-
payer's contentions. Furthermore, it appears that the taxpayer was not
furnished with a copy of the division's findings and its decision (in fact his
application for such copy was refused) and that the entire board, without giving
notice to the taxpayer, proceeded to give consideration to the findings and
decision of division No. 3.
The entire board reversed the decision of division No. 3, and the taxpayer
was notified only of this final decision. It is apparent from a reading of this
case that the mandamus was issued because the methods of the board did not
conform to the methods prescribed by the statute in the following particulars:
1. The findings of fact and decision were not made by a board that had heard
the taxpayer's appeal.
2. The case was reviewed without specific direction of the chairman.
3. The taxpayer was not notified of the findings and decision by division No.
3, nor of the fact that his case was to be reviewed by the entire board.
It is not clear from what appears in the court's decision that the thirty days'
period for direction of the review of a division's findings and decision had been
exceeded.
When one recalls with what punctiliousness the board regards the law as to
its jurisdiction and the sixty-day period in which an appeal must be delivered to
it, it is cause for wonder when the board adopts rules for its functioning that
are, apparently, at variance with the law controlling its activities.

SUMMARY OF RECENT RULINGS

Requirement that petition to board of tax appeals shall be filed within sixty
days after the mailing of a deficiency notice was not met where envelope con-
taining petition was placed in the slot of the door of the room where mail
addressed to the board was usually delivered, after the board's office had been
closed conformably with its published rules. (Court of appeals of the District
of Columbia, Lewis-Hall Iron Works v. David H. Blair, commissioner.)
Gain or loss resulting from sale during 1920, 1921 and 1922 of stock acquired
during 1920 by a residuary legatee should be computed upon the basis of the
fair market value of stock at the time of the distribution and not at the time of
the testator's death, nor when the new certificates were actually delivered.
(U. S. district court, W. D. New York, E. Franklin Brewster v. Bert Gage,
collector.)
Judgment against a suspended or defunct corporation is not a condition
precedent to a suit in equity against the directors or stockholders to whom there
has been distributed the property of the corporation. (U. S. district court,
S. D. California, S. D.; U. S. William P. and Jane D. Pann and Helen Donald.)
Six-year period of collection provided in 1924 act held applicable where a timely assessment was made prior to the passage of the act, and collection was not barred on June 2, 1924, date of the passage of the act. (U. S. district court, S. D. California, S. D.; U. S. v. William P. and Jane D. Pann and Helen Donald.)

Federal estate tax act of 1918, held unconstitutional as being a direct tax unapportioned in so far as it taxes the dower interest of a widow, or the estate accepted in lieu of dower, passing by operation of the laws of the state of Missouri. (U. S. district court, St. Joseph division of W. D. of Missouri; Mary Z. Hribbard, administratrix, v. Noah Crooks, collector.)

A lessor is not taxable on the amount of federal income tax paid by a lessee of its properties on the rental income received by such lessor under a lease providing for the payment of all taxes by the lessee. (U. S. district court, Massachusetts; Boston and Maine Railroad v. United States.)

Instruments were held to be bonds of indebtedness within the meaning of schedule A-1, title VIII, act of 1924, where containing a promise under seal, to pay a sum certain, incorporating by reference the terms of the mortgage given to secure their payment and issued in series by the corporation and designated for use as corporate securities. (U. S. district court, W. D. Pennsylvania; Bellhied Company v. D. B. Heiner, collector.)

The mere grant of a corporate charter in 1918 and the occasional use of the corporate name did not make a business corporate in law, where it is established by evidence that the business and the income therefrom did not belong to the corporation and the activities of such business were carried on in a partnership relation. Such corporation was held to have no income in 1919, and a suit under the trust fund doctrine against the stockholders of the dissolved corporation for taxes assessed against it was dismissed. (U. S. district court, Maryland; United States v. S. V. Jenlenko and D. G. Rosenstock.)

Where a subsidiary, keeping books on a calendar-year basis, of a corporation keeping books on a fiscal year basis, filed an income tax for 1917 in accordance with its books, and the parent corporation filed a consolidated excess-profits tax return for the period from January 1, 1917, to June 30, 1917, in accordance with its books, the commissioner has no authority to determine the 1917 net income of the subsidiary for any other taxable period than the entire calendar year 1917. (U. S. court of claims, Clinchfield Navigation Co., Inc. v. United States.)

Amounts paid through the delivery of coal at less than market price for the construction on the taxpayer's property of a branch line of railroad, thus giving the taxpayer railroad connections, may be included in invested capital. (U. S. circuit court of appeals; Ganley Mountain Coal Company v. Commissioner.)

The value of property transferred by the decedent in 1917 to trustees with full power and authority to deal with the same, to pay income thereof to the grantor's husband for life and after his death to the settlor, and after her death to distribute the corpus thereof, is properly included in the gross estate of the decedent as property intended to take effect in possession and enjoyment at or after her death. (U. S. district court, W. D. Pennsylvania; Walker A. May et al., executors, v. D. B. Heiner, collector.)

Royalties received, pursuant to a ten-year contract for production of phonograph records, during 1917 by a noted singer, on account of sales made during 1917 of records which had been produced prior to 1917, held subject to excess-profits tax, sec. 209, act of 1917. (U. S. district court, S. D. New York; Alma Gluck Zimbalist v. Charles W. Anderson.)

Taxes paid in order to avoid penalties and threatened seizure of property by distress after their collection had been barred by statute of limitations may be recovered. Sec. 1106 (a), act of 1926, was not intended to defeat recovery by taxpayer in such a situation. (U. S. district court, Massachusetts; Aroline C. Gove v. Malcolm E. Nichols, collector.)

A trustee in bankruptcy, having secured by his own motion an order from the referee fixing the amount of excise taxes payable for period from December, 1919, to January, 1922, inclusive, may not later reopen the case where no
Income-tax Department

allegations are made of fraud, accident or mistake in making the original order. (U. S. district court, W. D. Pennsylvania; In re Universal Rubber Products Company, bankrupt.)

A court has no power to enjoin the collection of a tax barred by the statute of limitations. Sec. 274 (a) act of 1926, permitting injunction pending an inquiry before the board of tax appeals extends only to the collection of a "deficiency" as defined by sec. 273, act of 1926, and is not applicable when no deficiency is asserted, in a case where the amount claimed by the government does not exceed amount shown to be due on the return though such amount was qualified by a simultaneous request for special assessment under secs. 327 and 328 (acts of 1918 and 1921), but without a substitute computation on the basis of such requested special assessment. (U. S. district court, N. D. Georgia, Atlanta; Peerless Woolen Mills v. J. T. Rose, collector.)

Deduction for federal estate tax may be made by an estate keeping its accounts on a cash receipts and disbursements basis only in the taxable year or years in which actually paid. (U. S. court of claims; Fourth and Central Trust Co., surviving executor, v. U. S.)

Building expert retained by board of local improvements, Chicago, in connection with valuation of buildings affected by certain local improvements, held not an officer or employee of a state or subdivision thereof, and, therefore, income received during 1920 and 1921 from such services is taxable. (U. S. court of claims; Frank H. Mesce v. United States.)

The lien of the United States for income taxes due from mortgager, is subordinate to the lien of the mortgage which was properly executed and recorded prior to the recording of the notice of tax lien. (U. S. district court, S. D. Florida; A. A. Ormsbee et al. v. United States.)

Dividends received in 1917 (declared by the corporation to be payable out of 1916 earnings) held taxable to the recipients at 1917 rates to the extent of the amount of the net profits of the corporation earned in 1917 prior to the date of the payment, the net profits for such period being determined by prorating the total profits earned during the entire year 1917. (U. S. court of claims; George D. Horst v. U. S.)

Bondholder owning bonds containing a tax-free covenant clause held not required to include in gross income for 1917 the amount of the 2% tax which debtor corporation paid to the government. (U. S. court of claims; George D. Horst v. U. S.)

A waiver filed by an executrix was held sufficient within the meaning of sec. 281 (e), act of 1924, to extend the time for filing claim for refund of taxes paid by the deceased taxpayer. (U. S. court of claims; Mary S. Aldridge, executrix, v. U. S.)

An agreement signed by an executor in regard to the property and the value thereof to be used in determining the estate tax was held not to be a compromise within rev. stat. sec. 3229, and not to bar suit by the executor for the recovery of estate taxes paid. (U. S. circuit court of appeals, first circuit; Robert M. Leach, executor, v. Malcolm E. Nichols, collector.)

The creator of an irrevocable trust was held not to be taxable upon the income received by the trustee from the trust property and payable to the husband of the creator of the trust for the benefit of their children. (U. S. district court, Connecticut; Jane B. O'Malley Keyes v. Robert O. Eaton, collector.)

The loss from operations in a foreign country was computed by taking the difference between the net current assets of the foreign branch at the beginning of the year, expressed in terms of United States money, and the net current assets of such branch at the end of the year, expressed in United States money, thus rejecting the government's method of computing the profit or loss in foreign money, and converting such profit into United States money at the close of the year. (U. S. district court, Connecticut; Frederick Victor and Achelis, et al., v. Salt's Textile Manufacturing Company.)

No loss can be taken on francs segregated from the business and set aside for financing a new enterprise, until these francs are converted into dollars by an actual exchange. (U. S. district court, Connecticut; Frederick Victor and Achelis v. Salt's Textile Manufacturing Company.)
No credit can be taken under sec. 238, act of 1918, for income and excess-profits taxes paid to France where from the viewpoint of dollar value, there was no income, but there was an income from the viewpoint of franc value. (U. S.
district court, Connecticut; Frederick Victor and Achelis v. Salt's Textile Manufacturing Company.)

Stockholders of a dissolved corporation were held liable for their contributory share of the corporation tax in the proportion which the stock held by them bore to the whole capital stock, where suit not against all stockholders. (U. S.
district court, New York district; U. S. v. E. H. Garcia et al.)

While assessments made against a corporation are probably not prima facie evidence of the amount due from stockholders after dissolution, admissions and concessions of the corporate officers are admissible. (U. S. district court, New York district; U. S. v. E. H. Garcia et al.)

The circumstances under which stock of a corporation was sold on a stock exchange, taking into consideration the company's property, goodwill and strategic position and the evidence of those most familiar with the property and most competent to estimate its value, were held sufficient to support a finding of the fair market value of the stock different from the price at which sold on the stock exchange. (U. S. circuit court of appeals, third circuit; D. B. Heiner, collector, v. Minnie F. Byles Crosby et al.)

The date of payment of a dividend and not the date of declaration is the date of distribution, and dividends declared in 1916 and 1917 and paid in 1917 are taxable at the 1916 or 1917 rates depending upon profits accumulated prior to date of payment. (Circuit court of appeals, third circuit; U. S. v. B. D. Phillips.)

Invested capital was reduced after January 25, 1918, by a dividend declared on that date, payable in cash or notes at the convenience of the company, the dividend being paid partly in cash and partly in notes. (U. S. district court, W. D. Pennsylvania; Logan-Gregg Hardware Company v. D. B. Heiner.)

The collection of a tax barred by the statute of limitations may be enjoined, for sec. 1106 (a), act of 1926, extinguishes the liability in such case and hence rev. stat. sec. 3224 does not operate. (Supreme court of the District of Columbia; Edward P. Merts v. Secretary of the Treasury.)

The cost of opening two shafts in a coal mine is amortizable under sec. 234 (a) (8), act of 1918, for it was not intended to restrict the meaning of “facilities” by the preceding words “buildings, machinery, equipment,” but rather to enlarge it to take in anything and everything contributing to the general result of winning the war. (Circuit court of appeals, fifth circuit; U. S. v. Corona Coal Company.)
Students' Department
H. A. Finney, Editor
H. P. Baumann, Associate Editor

AMERICAN INSTITUTE EXAMINATIONS

(Note.—The fact that these solutions appear in The Journal of Accountancy should not cause the reader to assume that they are the official solutions of the board of examiners. They represent merely the opinions of the editors of the Students' Department.)

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART II
November 18, 1927, 1 P. M. to 6 P. M.

No. 1 (25 points):
From the following balance-sheets and explanatory data, prepare a consolidated balance-sheet.
Submit your working papers relative thereto.

Company X
Balance-sheet—December 31, 1926
Assets
Cash .......................................................... $20,000
Investment in company Y—
1,400 shares, par value $100 ........................ 210,000 (1)
Investment in company Z—
4,000 shares, par value $50 ........................ 200,000 (2)

$430,000

Liabilities and Net Worth
Current liabilities ........................................ $80,000
Collateral gold notes, due 1934 ...................... 100,000
Capital stock—
Preferred: 1,000 shares, par value $100 ............ 100,000
Common: 10,000 shares, no par value .............. 150,000

$430,000

Company Y
Balance-sheet—October 31, 1926
Assets
Cash .......................................................... $60,000
Receivables ................................................. 100,000 (3)
Inventories .................................................. 300,000 (4)

$460,000

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**Liabilities and Net Worth**

<table>
<thead>
<tr>
<th>Accounts payable</th>
<th>$16,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital stock—</td>
<td>400,000</td>
</tr>
<tr>
<td>4,000 shares, par value $100</td>
<td></td>
</tr>
<tr>
<td>Surplus—</td>
<td>$40,000</td>
</tr>
<tr>
<td>Balance, Nov. 1, 1925</td>
<td></td>
</tr>
<tr>
<td>Add: Profit for year</td>
<td>14,000</td>
</tr>
<tr>
<td>$54,000</td>
<td></td>
</tr>
<tr>
<td>Less: Dividends paid Oct. 31, 1926</td>
<td>10,000</td>
</tr>
<tr>
<td>$44,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$460,000</td>
</tr>
</tbody>
</table>

**Company Z**

Balance-sheet—December 31, 1926

**Assets**

<table>
<thead>
<tr>
<th>Cash</th>
<th>$10,000 (5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables</td>
<td>40,000 (8)</td>
</tr>
<tr>
<td>Inventories</td>
<td>100,000</td>
</tr>
<tr>
<td>Investment in company Y—</td>
<td>120,000 (6)</td>
</tr>
<tr>
<td>800 shares, par value $100</td>
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</tr>
<tr>
<td>Investment in company X—</td>
<td>25,000 (7)</td>
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<tr>
<td>250 shares, preferred, par value $100</td>
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<tr>
<td>Land, buildings and equipment, as appraised by General Appraisal Co., Dec. 31, 1926, at sound value of</td>
<td>113,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$408,000</td>
</tr>
</tbody>
</table>

**Liabilities and Net Worth**

<table>
<thead>
<tr>
<th>Accounts payable</th>
<th>$133,000</th>
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</thead>
<tbody>
<tr>
<td>Capital stock—</td>
<td>200,000</td>
</tr>
<tr>
<td>4,000 shares, par value $50</td>
<td></td>
</tr>
<tr>
<td>Surplus—</td>
<td>$100,000</td>
</tr>
<tr>
<td>Balance, January 1, 1926</td>
<td></td>
</tr>
<tr>
<td>Deficit for year 1926</td>
<td>25,000</td>
</tr>
<tr>
<td></td>
<td>75,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$408,000</td>
</tr>
</tbody>
</table>

**Notes:**

1. Purchased October 31, 1926, at $150 per share.
2. Purchased January 1, 1926, at $90 per share.
3. Includes $20,000 due from Z company.
4. Includes $50,000 goods purchased from company Z.
5. After remitting $25,000 to company X, which is in transit.
6. Purchased October 31, 1926, at $150 per share.
7. Acquired at par.
8. Includes $25,000 advanced to company X.

**Solution:**

Following is a key to adjustments and eliminations in the working papers on pages 216 and 217:

A Eliminates receivable by Co. Y and payable by Co. Z.
B Takes up (as on Co. X's books) cash in transit from Co. Z.
C Eliminates Co. X's payable and Co. Z's receivable for cash advance.
D Eliminates par value of Co. Y stock held by Co. X.
E Eliminates surplus at acquisition applicable to above stock.
F Eliminates par value of Co. Y stock held by Co. Z.
Students' Department

G Eliminates surplus at acquisition applicable to above stock.
H Eliminates par value of Co. X preferred stock held by Co. Z.
I Sets up Co. Z stock owned by Co. X at stated cost:
   Cost—4,000 shares at $90.00 $360,000.00
   Carrying value 200,000.00
   Difference presumably written off by Co. X by charge to surplus $160,000.00
J Eliminates par value of Co. Z stock held by Co. X.
K Eliminates surplus at acquisition applicable to above stock.

Adjustment B is based on what appears to be the more logical of two possible assumptions. Company Z may have been carrying an account payable with company X which was closed by the remittance, or company Z may have charged the remittance to its receivables. The first assumption would mean that company Z had taken the liability on its books and paid it before company X even took up the item as a receivable, for no receivables appear on books of company X. While this might be possible it seems more probable that company Z's remittance represented an advance which it recorded by a charge to its receivables, and which company X will take up by a credit to an account payable. The treatment given the item in adjustment B is based on this assumption.

As to elimination H, it is assumed that the preferred stock is non-participating and that no dividends are in arrears.

Adjustment I was made on the assumption that company X wrote down the Z stock by charge to its surplus account. It is possible that the charge was made to the no-par-value common capital-stock account, and in that case the credit of $160,000 in adjustment I should be made to capital stock.

Company X and Subsidiary Companies Y and Z
Consolidated balance-sheet, December 31, 1926 (see note)

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<tr>
<th>Assets</th>
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<tbody>
<tr>
<td>Cash</td>
<td>$115,000.00</td>
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<tr>
<td>Receivables</td>
<td>95,000.00</td>
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<tr>
<td>Inventories</td>
<td>400,000.00</td>
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<tr>
<td>Land, buildings and equipment</td>
<td>113,000.00</td>
</tr>
<tr>
<td>Goodwill</td>
<td>145,800.00</td>
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<tr>
<td></td>
<td>$868,800.00</td>
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</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
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</thead>
<tbody>
<tr>
<td>Accounts payable and other current liabilities</td>
<td>$209,000.00</td>
</tr>
<tr>
<td>Collateral gold notes, due in 1934</td>
<td>100,000.00</td>
</tr>
<tr>
<td>Minority interest—45%—in company Y:</td>
<td></td>
</tr>
<tr>
<td>Capital stock</td>
<td>$180,000.00</td>
</tr>
<tr>
<td>Surplus</td>
<td>19,800.00</td>
</tr>
<tr>
<td></td>
<td>199,800.00</td>
</tr>
</tbody>
</table>
### COMPANY X AND SUBSIDIARIES

**Consolidated balance-sheet — working papers, December 31, 1926**

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>20,000.00</td>
<td>60,000.00</td>
<td>10,000.00</td>
<td></td>
<td></td>
<td>$90,000.00</td>
</tr>
<tr>
<td>Investment in company Y:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,400 shares, par value $100</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eliminate book value at acquisition:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital stock</td>
<td></td>
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</tr>
<tr>
<td>Surplus—1/4 of $44,000.</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in company Z:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4,000 shares, par value $30</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eliminate book value at acquisition:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital stock</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Surplus</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in company Y:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>800 shares, par value $100</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eliminate book value at acquisition:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital stock</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Surplus—8/40 of $44,000.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in company X:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>250 shares, preferred, par value $100</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eliminate par value</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land, buildings and equipment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash in transit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Eliminations</th>
<th>Consolidated balance-sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>$140,000.00 D</td>
<td>$54,600.00 G</td>
</tr>
<tr>
<td>15,400.00 E</td>
<td>95,000.00</td>
</tr>
<tr>
<td>20,000.00 A</td>
<td>400,000.00</td>
</tr>
<tr>
<td>25,000.00 C</td>
<td>60,000.00 G</td>
</tr>
<tr>
<td>25,000.00 H</td>
<td>113,000.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Adjustments</th>
<th>Consolidated balance-sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>$120,000.00</td>
<td>$31,200.00 G</td>
</tr>
<tr>
<td>8,000.00 G</td>
<td>25,000.00 H</td>
</tr>
<tr>
<td>25,000.00 B</td>
<td>113,000.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Eliminations</th>
<th>Consolidated balance-sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>$614,200.00</td>
<td>$868,800.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Adjustments</th>
<th>Consolidated balance-sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>$480,000.00</td>
<td>$430,000.00</td>
</tr>
<tr>
<td>10,000.00</td>
<td>10,000.00</td>
</tr>
<tr>
<td>80,000.00 F</td>
<td>80,000.00</td>
</tr>
<tr>
<td>25,000.00</td>
<td>25,000.00</td>
</tr>
<tr>
<td>25,000.00</td>
<td>25,000.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Eliminations</th>
<th>Consolidated balance-sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>$460,000.00</td>
<td>$408,000.00</td>
</tr>
<tr>
<td>25,000.00 B</td>
<td>25,000.00</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$80,000.00</td>
</tr>
<tr>
<td>---------------------------------------------------------------------------</td>
<td>------------</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>$80,000.00</td>
</tr>
<tr>
<td>Collateral gold notes, due 1934</td>
<td>100,000.00</td>
</tr>
<tr>
<td>Accounts payable</td>
<td></td>
</tr>
<tr>
<td>Capital stock</td>
<td></td>
</tr>
<tr>
<td>Company X:</td>
<td></td>
</tr>
<tr>
<td>Preferred, 1,000 shares</td>
<td>100,000.00</td>
</tr>
<tr>
<td>Common, 10,000 shares no par value</td>
<td>150,000.00</td>
</tr>
<tr>
<td>Accounts payable</td>
<td></td>
</tr>
<tr>
<td>Company Y, 4,000 shares, par value $100</td>
<td>400,000.00</td>
</tr>
<tr>
<td>Eliminate par value of stock held by Co. X</td>
<td></td>
</tr>
<tr>
<td>Eliminate par value of stock held by Co. Z</td>
<td></td>
</tr>
<tr>
<td>Minority interest</td>
<td></td>
</tr>
<tr>
<td>Company Z—4,000 shares, par value $50</td>
<td></td>
</tr>
<tr>
<td>Eliminate par value of stock held by Co. X</td>
<td></td>
</tr>
<tr>
<td>Surplus:</td>
<td></td>
</tr>
<tr>
<td>Company X:</td>
<td></td>
</tr>
<tr>
<td>Adjustment to restore Z stock to cost—$90 per share</td>
<td></td>
</tr>
<tr>
<td>Company Y</td>
<td>44,000.00</td>
</tr>
<tr>
<td>Eliminate surplus applicable to X's holdings—14/40</td>
<td></td>
</tr>
<tr>
<td>Eliminate surplus applicable to Z's holdings—8/40</td>
<td></td>
</tr>
<tr>
<td>Remainder, minority interest—18/40</td>
<td></td>
</tr>
<tr>
<td>Company Z</td>
<td>75,000.00</td>
</tr>
<tr>
<td>Eliminate surplus at date of acquisition of entire stock issue by Co. X</td>
<td></td>
</tr>
<tr>
<td>Deficit since acquisition</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>$430,000.00</th>
<th>$460,000.00</th>
<th>$408,000.00</th>
<th>$185,000.00</th>
<th>$185,000.00</th>
<th>$614,200.00</th>
<th>$688,800.00</th>
</tr>
</thead>
</table>
The Journal of Accountancy

Capital stock—company X:
  Preferred ........................................... $75,000.00
  Common ............................................. 150,000.00
  Surplus ............................................ 135,000.00

  Total .................................................. $360,000.00 64.3%

Minority:
  Capital stock ..................................... $180,000.00
  Surplus ............................................. 19,800.00

  Total minority ....................................... 199,800.00 35.7%

  Total .................................................. $559,800.00

Note.—The balance-sheet of company Y consolidated in the above statement, was as of October 31, 1926, none being available as of December 31, 1926.

Comments:
  Mention is made in the problem of goods owned by company Y which were purchased from company Z. Since the purchases were made prior to the date of inter-company stock acquisitions, the profit or loss (if any) was not inter-company profit, and hence may be ignored. For this reason the absence of information in the problem as to the profit made by company Z is of no import.

  Accountants are occasionally confronted with the question of the propriety of consolidating balance-sheets as of different dates. This is particularly true when subsidiaries are in foreign countries. There is no serious objection to making such a consolidation, provided the facts are stated and further provided there is no reason to assume that radical changes have occurred in the financial condition of the subsidiary since the date of its balance-sheet.

  There is, however, another reason to question seriously the propriety of including the balance-sheet of company Y in the consolidation. Companies X and Z together own only 55 per cent. of the stock of company Y, and the minority interest of 45 per cent. is very large. As shown by the consolidated balance-sheet, the relative interests of the holding company and the minority in the consolidated net assets are:

  Holding company:
    Preferred stock .................................. $75,000.00
    Common stock ................................... 150,000.00
    Surplus ........................................... 135,000.00

    Total holding company ........................... $360,000.00 64.3%

  Minority:
    Capital stock .................................... $180,000.00
    Surplus ........................................... 19,800.00

    Total minority .................................... 199,800.00 35.7%

    Total ............................................... $559,800.00

  While a balance-sheet consolidating the accounts of company Y has been given because apparently required by the problem, it appears to the editors of this department that much might be said in favor of consolidating the balance-sheets of only companies X and Z, and including as one item therein the investment in company Y.
### COMPANY X AND SUBSIDIARY Z

Consolidated balance-sheet—working papers, December 31, 1926

<table>
<thead>
<tr>
<th>Assets</th>
<th>Company X</th>
<th>Company Z</th>
<th>Adjustments</th>
<th>Eliminations</th>
<th>Consolidated balance-sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20,000.00</td>
<td>$10,000.00</td>
<td></td>
<td></td>
<td>$30,000.00</td>
</tr>
<tr>
<td>Investment in Co. Y</td>
<td>210,000.00</td>
<td>120,000.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Co. Z</td>
<td>200,000.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adjustment to raise to cost</td>
<td></td>
<td></td>
<td>$160,000.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Eliminate book value at acquisition:
- Capital stock: Company X: $100,000.00
- Capital stock: Company Z: $200,000.00
- Surplus: Company X: $160,000.00
- Surplus: Company Z: $75,000.00
- Goodwill: Company X: $60,000.00

Reclassify as due to affiliated company—Y:
- Accounts payable: $133,000.00

Current liabilities: $80,000.00
Collateral gold notes: $100,000.00
Accounts payable: $133,000.00

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td>$80,000.00</td>
<td></td>
<td></td>
<td></td>
<td>$80,000.00</td>
</tr>
<tr>
<td>Collateral gold notes</td>
<td>$100,000.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td></td>
<td></td>
<td>$133,000.00</td>
<td>$20,000.00 A</td>
<td></td>
</tr>
<tr>
<td>Reclassify as due to affiliated company—Y</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital stock: Company X:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Preferred</td>
<td>100,000.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common</td>
<td>150,000.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company Z</td>
<td>200,000.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Surplus:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company X</td>
<td></td>
<td></td>
<td></td>
<td>160,000.00 I</td>
<td>$160,000.00</td>
</tr>
<tr>
<td>Company Z</td>
<td></td>
<td></td>
<td></td>
<td>100,000.00 K</td>
<td>$25,000.00 *</td>
</tr>
</tbody>
</table>

Total liabilities: $350,000.00
Total assets: $673,000.00
Company X and Subsidiary Z
Consolidated balance-sheet, December 31, 1926

Assets

<table>
<thead>
<tr>
<th>Description</th>
<th>Company X and Subsidiary Companies Y and Z</th>
<th>Company X and Subsidiary Company Z</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$115,000.00</td>
<td>$55,000.00</td>
<td>$60,000.00</td>
</tr>
<tr>
<td>Receivables</td>
<td>95,000.00</td>
<td>15,000.00</td>
<td>80,000.00</td>
</tr>
<tr>
<td>Inventories</td>
<td>400,000.00</td>
<td>100,000.00</td>
<td>300,000.00</td>
</tr>
<tr>
<td>Land, buildings and equipment</td>
<td>113,000.00</td>
<td>113,000.00</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>145,800.00</td>
<td>60,000.00</td>
<td>85,800.00</td>
</tr>
<tr>
<td>Investment in Co. Y</td>
<td></td>
<td>330,000.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$868,800.00</td>
<td>$673,000.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$195,800.00</td>
</tr>
</tbody>
</table>

*Red.

This balance-sheet is subject to as much criticism as the preceding one which included the assets and liabilities of company Y, for practically 50 per cent. of the total assets are represented by the investment in company Y, and the balance-sheet gives no evidence of the assets which this investment represents. The amounts of company Y's inventories and receivables are very significant in proportion to those of the consolidation (excluding Y), and the consolidated status as to working assets is not clearly stated when Y's balance-sheet is excluded from the consolidation.

The problem furnishes an excellent illustration of the dilemma presented to the accountant by a consolidation where control is maintained on the basis of a scant majority of stock ownership.

As a matter of interest the following comparison of the consolidated balance-sheets prepared under the two possibilities enumerated above is submitted.

<table>
<thead>
<tr>
<th>Description</th>
<th>Company X and Subsidiary Companies Y and Z</th>
<th>Company X and Subsidiary Company Z</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$55,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>15,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>100,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land, buildings and equipment</td>
<td>113,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>60,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Co. Y</td>
<td>330,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$673,000.00</td>
<td></td>
</tr>
</tbody>
</table>

*Cost.

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Students' Department

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Company X and subsidiary companies Y and Z</th>
<th>Company X and subsidiary company Z</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and other current liabilities</td>
<td>$209,000.00 $213,000.00</td>
<td></td>
<td>$4,000.00</td>
</tr>
<tr>
<td>Collateral gold notes, due in 1934</td>
<td>100,000.00</td>
<td>100,000.00</td>
<td></td>
</tr>
<tr>
<td>Minority interest in Co. Y</td>
<td>199,800.00</td>
<td>199,800.00</td>
<td></td>
</tr>
<tr>
<td>Capital stock—Co. X:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Preferred</td>
<td>75,000.00</td>
<td>75,000.00</td>
<td></td>
</tr>
<tr>
<td>Common</td>
<td>150,000.00</td>
<td>150,000.00</td>
<td></td>
</tr>
<tr>
<td>Surplus</td>
<td>135,000.00</td>
<td>135,000.00</td>
<td></td>
</tr>
<tr>
<td>* Red.</td>
<td>$868,800.00</td>
<td>$673,000.00</td>
<td>$195,800.00</td>
</tr>
</tbody>
</table>

No. 3 (20 points):
From the statements following, submitted by Brown & Jones (a copartnership) conducting a retail grocery store, prepare a profit-and-loss account for the year ended December 31, 1926, and the capital accounts of the partners who share equally in the profits:

Balance-sheets—December 31, 1926 and 1925

<table>
<thead>
<tr>
<th>Assets</th>
<th>December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1926</td>
</tr>
<tr>
<td>Current:</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$10,500</td>
</tr>
<tr>
<td>Customers’ accounts receivable</td>
<td>55,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>105,000</td>
</tr>
<tr>
<td>Total current assets</td>
<td>$170,500</td>
</tr>
<tr>
<td>Prepaid:</td>
<td></td>
</tr>
<tr>
<td>Insurance and real-estate taxes</td>
<td>$2,500</td>
</tr>
<tr>
<td>Fixed—at cost, less depreciation:</td>
<td></td>
</tr>
<tr>
<td>Real estate</td>
<td>$15,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>55,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>9,000</td>
</tr>
<tr>
<td>Motor vehicles, etc.</td>
<td>10,000</td>
</tr>
<tr>
<td>Total fixed assets</td>
<td>$89,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$262,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notes payable—bank</td>
<td>$50,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Trade accounts payable</td>
<td>15,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Manager’s bonus</td>
<td>2,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>$67,000</td>
<td>$51,000</td>
</tr>
<tr>
<td>Capital:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>John Brown</td>
<td>$125,000</td>
<td>$104,000</td>
</tr>
<tr>
<td>David Jones</td>
<td>70,000</td>
<td>84,750</td>
</tr>
<tr>
<td>Total capital</td>
<td>$195,000</td>
<td>$188,750</td>
</tr>
<tr>
<td>Total liabilities and capital</td>
<td>$262,000</td>
<td>$239,750</td>
</tr>
</tbody>
</table>

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# Trial balance after closing December 31, 1925

<table>
<thead>
<tr>
<th>Account</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$7,500</td>
<td></td>
<td>(a) $594,250</td>
<td></td>
</tr>
<tr>
<td>Customers' accounts receivable</td>
<td>51,000</td>
<td></td>
<td>(b) $591,250</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>90,000</td>
<td></td>
<td>(c) 504,000</td>
<td></td>
</tr>
<tr>
<td>Prepaid insurance and real-estate taxes</td>
<td>2,250</td>
<td></td>
<td>(a) 500,000</td>
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</tr>
<tr>
<td>Real estate</td>
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<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>57,000</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>10,000</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Motor vehicles, etc.</td>
<td>12,000</td>
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<td>(b) 3,500</td>
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</tr>
<tr>
<td>Notes payable—bank</td>
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<td>$40,000</td>
<td>(b) 80,000</td>
<td>(a) 90,000</td>
</tr>
<tr>
<td>Trade accounts payable</td>
<td>10,000</td>
<td></td>
<td>(b) 400,000</td>
<td>(d) 405,000</td>
</tr>
<tr>
<td>Manager's bonus</td>
<td>1,000</td>
<td></td>
<td>(b) 1,000</td>
<td></td>
</tr>
<tr>
<td>John Brown, capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>David Jones, capital</td>
<td></td>
<td>104,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>84,750</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Total** $239,750  $239,750

# Transactions for the year ended December 31, 1926

<table>
<thead>
<tr>
<th>Account</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase allowances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Haulage, etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wages of store assistants</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wages of drivers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Miscellaneous expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discount on notes payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>John Brown, drawing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>David Jones, drawing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance and real-estate taxes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(d) 405,000</td>
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**Total** $2,094,500  $2,094,500

# Net profit for year ended December 31, 1926

222
Students' Department

JONES ended December 31, 1926

<table>
<thead>
<tr>
<th>Adjustments</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
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<td>1</td>
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</table>

<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
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<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
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<tr>
<td>2,000</td>
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<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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</tr>
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<td>750</td>
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<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
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<td></td>
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<td>15,525</td>
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<td>51,275</td>
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<tr>
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<td></td>
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<td>(2) 90,000</td>
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<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
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<tr>
<td>$208,250</td>
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<td></td>
<td>$764,000</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
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</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>$508,250</td>
<td></td>
<td></td>
<td>$328,800</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$508,250</td>
<td></td>
<td></td>
<td>$328,800</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

223
Cash receipts and disbursements, year ended December 31, 1926

Cash on hand—December 31, 1926

<table>
<thead>
<tr>
<th>Receipts:</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customers</td>
<td>500,000</td>
</tr>
<tr>
<td>Rent of apartments above stores</td>
<td>2,000</td>
</tr>
<tr>
<td>Suppliers—allowances on defective goods</td>
<td>750</td>
</tr>
<tr>
<td>Haulage, etc</td>
<td>1,500</td>
</tr>
<tr>
<td>Notes payable discounted</td>
<td>90,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Disbursements:</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesalers</td>
<td>$400,000</td>
</tr>
<tr>
<td>Wages of store assistants</td>
<td>15,000</td>
</tr>
<tr>
<td>Wages of drivers</td>
<td>7,500</td>
</tr>
<tr>
<td>Miscellaneous expenses, including telephone, etc.</td>
<td>6,000</td>
</tr>
<tr>
<td>Manager's bonus—year 1925</td>
<td>1,000</td>
</tr>
<tr>
<td>Notes payable</td>
<td>80,000</td>
</tr>
<tr>
<td>Discount on notes payable</td>
<td>3,450</td>
</tr>
<tr>
<td>Insurance and real-estate taxes</td>
<td>3,000</td>
</tr>
<tr>
<td>John Brown</td>
<td>15,525</td>
</tr>
<tr>
<td>David Jones</td>
<td>51,275</td>
</tr>
<tr>
<td>Real estate purchased</td>
<td>5,000</td>
</tr>
<tr>
<td>Motor vehicles purchased</td>
<td>3,500</td>
</tr>
</tbody>
</table>

Cash on hand—December 31, 1926

<table>
<thead>
<tr>
<th>Amount</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$7,500</td>
</tr>
</tbody>
</table>

Solution:

The transactions for the period are shown by the working papers on pages 222 and 223, which also show the reconstruction of the nominal accounts for the year ended December 31, 1926:

Transactions for the year ended December 31, 1926:

(a) To record cash receipts for the year ended December 31, 1926.
(b) To record cash disbursements for the year ended December 31, 1926.
(c) To record sales for the year ended December 31, 1926, which are computed as follows:

| Amount of accounts receivable December 31, 1926 | $55,000.00 |
| Received from customers during year            | 500,000.00 |
| Total                                           | $555,000.00 |
| Less:                                           |            |
| Amount of accounts receivable December 31, 1925 | 51,000.00  |
| Balance, representing amount of 1926 sales      | $504,000.00 |

(d) To record purchases for the year ended December 31, 1926, which are computed as follows:

| Amount of trade accounts payable December 31, 1926 | $15,000.00 |
| Payments to wholesalers during year               | 400,000.00 |
| Total                                             | $415,000.00 |
| Amount of trade accounts payable December 31, 1925 | 10,000.00  |
| Balance, representing amount of 1926 purchases    | $405,000.00 |
### Profit and loss, 1926

<table>
<thead>
<tr>
<th>1926</th>
<th>F</th>
<th>1926</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31 Inventory, January 1, 1926</td>
<td>J $90,000.00</td>
<td>Dec. 31 Sales</td>
<td>J $504,000.00</td>
</tr>
<tr>
<td>31 Purchases</td>
<td>J 405,000.00</td>
<td>31 Inventory, December 31, 1926</td>
<td>J 105,000.00</td>
</tr>
<tr>
<td>31 Wages, store assistants</td>
<td>J 15,000.00</td>
<td>31 Rental income</td>
<td>J 2,000.00</td>
</tr>
<tr>
<td>31 Wages, drivers</td>
<td>J 7,500.00</td>
<td>31 Purchase allowances</td>
<td>J 750.00</td>
</tr>
<tr>
<td>31 Miscellaneous expense</td>
<td>J 6,000.00</td>
<td>31 Haulage, etc.</td>
<td>J 1,500.00</td>
</tr>
<tr>
<td>31 Discount on notes payable</td>
<td>J 3,450.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31 Insurance and real-estate taxes</td>
<td>J 2,750.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31 Manager's bonus</td>
<td>J 2,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31 Depreciation, buildings</td>
<td>J 2,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31 Depreciation, equipment</td>
<td>J 1,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31 Depreciation, motor vehicles</td>
<td>J 5,500.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31 John Brown, capital</td>
<td>J 36,525.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31 David Jones, capital</td>
<td>J 36,525.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

$613,250.00

---

### John Brown, capital

<table>
<thead>
<tr>
<th>1926</th>
<th>F</th>
<th>1926</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31 John Brown, drawing</td>
<td>J $15,525.00</td>
<td>Jan. 1 Balance</td>
<td>J $104,000.00</td>
</tr>
<tr>
<td>Balance</td>
<td>J 125,000.00</td>
<td>Dec. 31 Profit and loss.</td>
<td>J 36,525.00</td>
</tr>
</tbody>
</table>

$140,525.00

---

### David Jones, capital

<table>
<thead>
<tr>
<th>1926</th>
<th>F</th>
<th>1926</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31 David Jones, drawing</td>
<td>J $51,275.00</td>
<td>Jan. 1 Balance</td>
<td>J $84,750.00</td>
</tr>
<tr>
<td>Balance</td>
<td>J 70,000.00</td>
<td>Dec. 31 Profit and loss.</td>
<td>J 36,525.00</td>
</tr>
</tbody>
</table>

$121,275.00

---

### David Jones, capital

<table>
<thead>
<tr>
<th>1927</th>
<th>F</th>
<th>1927</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1 Balance</td>
<td>J $70,000.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The Journal of Accountancy

Adjusting entries, December 31, 1926:
(1) To record insurance and real-estate taxes for the year ended December 31, 1926, computed as follows:

Prepaid insurance and real-estate taxes, December 31, 1925 $2,250.00
Insurance and real-estate taxes paid during year 3,000.00

Total $5,250.00
Prepaid insurance and real-estate taxes, December 31, 1926 2,500.00

Balance, representing expense for 1926 $2,750.00

(2) To close to purchases account the inventories at December 31, 1925.
(3) To record inventories at December 31, 1926.
(4) To record manager's bonus for the year 1926.
(5), (6) and (7) To record depreciation for the year 1926.

The profit-and-loss account for the year ended December 31, 1926, and the partners' capital accounts can now be prepared from the working papers (see page 225).
Book Reviews


The authors state that Ratio Analysis of Financial Statements is prepared on the principle that the intelligent granting of credit rests on three tests: First, the fair and proper preparation of the individual statements, together with a proper standardization of the meanings of terms and usage of nomenclature; second, a fair and sound method of analytical selection of typical data; third, the application of the principles of analysis to these data. The purpose of the volume is to explain the system of ratio analysis, and it covers such related subjects as are deemed necessary for a complete explanation of the system.

The authors have attempted very successfully to set forth the natural groupings on the balance-sheet and explain their significance. Commencing with the old rule of two for one in current assets to current liabilities, numerous other ratios are suggested for the guidance of the credit man in studying the trend of a business from period to period.

In an appendix will be found a number of statement analyses made by the methods advocated in the volume.

This book has been written in a simple non-technical style and should be of considerable value to the accountant, as well as the credit man, in his work. The tendency today is for the accountant to include in his formal report the result of his analysis of the statements, which generally can best be presented in percentages and charts. A careful reading of Ratio Analysis of Financial Statements should be very helpful to him if he believes such an analysis is of value to his client.

F. H. Hurdman.


Written for the "purpose of emphasizing the necessity for greater and more effective understanding and cooperation between accountants and their clients or employers" (p. vii), Mr. Esquerré's Accounting is practically a plea to the profession to get away from hide-bound tradition and rigid forms in auditing accounts and stating results. At that there is little in the book that can be regarded as radical in the light of experience of late years. There was a time when the author's caustic comments on the illogical custom of determining the profits of a past year by deducting the possible losses of the next were considered heretical and dangerous, but today the most conservative of us have had our confidence in the time-honored rule of "cost or market, whichever is lower" rudely shaken. And so, too, present-day auditors have learned that balance-sheets and statements to be of any real value to clients may assume various forms suitable to their purposes and needs without violating fundamental principles. The auditor who can not, or will not, ascertain the peculiar (and legitimate, of course) needs of his client, and make his statements conform there-to, simply does not know his business. All this may sound platitudinous today, but the credit of being a pioneer on this line is certainly due to the author of this book.

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In the main the author follows the stereotyped routine in presenting the subject of general accounting, but in effect the book is more a series of philosophical discussions of the form and meaning of different phases of balance-sheets and financial statements on a much higher plane than is found in the conventional textbook. In fact, I should not call it a textbook at all in spite of its dedication "to the studious youths of the nation." It is really a study of the philosophy of accounting and more likely to find due appreciation by the accountant of experience than by the average student. The latter may learn principles by rote but the pungent satire of many of the author's criticisms will be over the student's head until he comes in contact with similar situations in actual experience. Another class to which the book would be of distinct value is that of directors of corporations, those unlucky but well meaning people who would like to do their full duty by their stockholders but are unable to understand the significance of the financial statements laid before them by the executives. One of the many striking passages in the book is:

"Directors do not share responsibility in proportion to their importance in, or influence upon, the board; they share alike" (p. 78).

How many unfortunate directors would have avoided loss and shame had they realized this!

The most significant chapter in the book is, of course, that on "The valuation of inventories" in which the author pays his respects to the rule of "cost or market"; and also points out the fallacies of the "retail inventory method", though he concedes the latter is "expedientious and sufficiently sane to be of great value to all who use it." His main contention is that actual cost is the only true and logical basis for determining the profit or loss on merchandise sold by a going concern—a contention which I believe is sound and will ultimately prevail.

There is an interesting, if somewhat violent, discussion of capital stock of no par value (chap. XIX) which seems rather academic on the whole. I think it may be granted that the advocates of no-par stock have been rather disappointed with its meagre results. It has not, indeed, brought about the hoped-for millennium in corporation stock accounting. But I think Mr. Esquerré's generous sympathies for the innocent victims of stock swindlers have somewhat obscured his usually keen sense of logic. There were just as unscrupulous promotors in the old days of par stock as now, and the age-old doctrine of caveat emptor is just as applicable to investors today as then. There may have been over-enthusiastic advocates of the no-par-stock laws who thought that they would automatically bar stock swindling, but no sane man believed then, or believes now, that any law can prevent a fool from parting with his money. Mr. Esquerré makes out a strong and plausible case for the "innocent investor", but there is not a word of it which is not equally applicable to par-stock laws. The trouble is not with the laws but with the abuse of them. On the other hand I think Mr. Esquerré will admit on second thought that the no-par-stock laws have facilitated the formation of honest and legitimate corporations where the capital value to be exploited was problematical and a matter for future development.

In the familiar blue binding and excellent print of the publishers, Accounting is well worth a place on the shelf of the accountant and the business man.

W. H. LAWTON.

_The Etiquette of the Accountancy Profession_, a little book of 85 pages, is a reprint of articles from _The Accountant_. The author is anonymous. The articles are said to have been read and revised by the late Sir Arthur Whinney and the present volume contains a foreword by Sir William Plender. The author, himself, in a short introduction, recognizes "that professional ethics and professional etiquette are neither of them fixed and unalterable" and states his purpose to be "to guide the practitioner, and particularly the young practitioner, in doubtful cases" and whenever practicable to "distinguish between what must be done by those who wish to avoid the pains and penalties of unprofessional conduct, and what in our judgment should guide those who aim at something higher. It will, we hope, be recognized that it is not always practicable to draw the line quite clearly between these two somewhat different standards of professional conduct."

The last quotation furnishes a clue to the point of view assumed by the author in dealing with the questions and problems which are discussed in a high minded, but in a very reasonable, undogmatic and altogether admirable manner.

Much of the book is devoted to points which arise in English practice but substantially never arise in American practice, so that this review must be limited to a few quotations (and comments thereon) from chapters which deal with matters of interest to American practitioners. Discussions which deal with questions arising from accountants' service as trustees or receivers in bankruptcy, as liquidators, as arbitrators or umpires, as estate agents, from their practice as auctioneers or stockbrokers, or the operation of trade protective associations, etc., and discussions which deal with the English custom of election of auditors by stockholders have no applicability to American practice. These functions are not performed by American accountants (at least not as accountants) and stockholders seldom, if ever, have anything to say about who is employed to make an audit.

A thing which interested the reviewer was the implied distinction between professional etiquette and professional ethics, although the author also implies, in several instances, that these distinctions shade into each other so that no clear line of demarcation can be drawn between the two subjects.

The following quotation from the foreword is especially apt:

"Correctness in professional conduct can not be derived only from the study of books; it is rather a matter of conscience than of codification. Professional ethics and professional etiquette are not from their nature immutable; and quite apart from the fact that every case has to be judged on its own merits, which involves, or is thought to involve, infringement of professional etiquette, there remains the fact that in a great number of instances more than one view can legitimately be held."

During the years in which this reviewer was officially charged with the duty of interpreting and administering the American Institute's rules of professional conduct, he often said that placing the emphasis upon the letter of the precept or rule rather than upon its spirit was not the proper mental attitude to take toward one's profession nor was it a course which would tend to advance its dignity. If a line of conduct offends either an intelligent conscience or the
canons of good taste, it is very apt to be an infraction of an ethical precept regardless of the fact that it may not, literally and specifically, be defined in the rule. Indeed, it is possible for an act to be a literal violation of some rule and be not at all unethical or in bad taste.

Of course, the person who is deficient in conscience or who is lacking in good taste or who from unworthy motives is inclined to violate conscience and good taste must be restrained by the letter of the law. The others do not need a law; they regulate themselves. I am reminded of a discussion I heard in my youth. At a dinner, the candidacy of a United States senator was being discussed. An editor of what was then deemed to be a radical paper (today it would be considered as ultra-conservative, if not reactionary) said that the candidate in question had no conscience. To this a lawyer friend of the candidate replied, "You are wrong—entirely wrong," but after some hesitation he added, "Yes, he has all sorts of conscience but he keeps it under blank good control." It is these kinds of people for whom rules must be made and laws enforced.

The following quotations are illustrative of the English point of view which is also the American point of view.

From the chapter on advertising:

"No doubt it (the rule) is based upon the general practice of all professional bodies, and is regarded as a necessary rule to uphold the proper dignity of these professions. Incidentally, it may be pointed out that, if advertising were permitted, the tendency would be for accountancy business to go to those accountants who advertised most effectively, and whatever might be said about this from the point of view of the clients' interest, the custom would add greatly to the current working expenses of the practising accountant."

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From the chapter on giving estimates as to profits:

"In the ordinary course chartered accountants must confine their reports to the facts, as disclosed by the books and supporting documents they are called upon to examine and report upon, and must leave it to others to draw deductions."

From the chapter on "What is legitimate accountancy":

"From our point of view, it is 'legitimate accountancy' for the professional accountant to promote the interests of his clients in any legitimate way connected not merely with account keeping but also with business management, organization, or finance. When, therefore, we are asked to discuss the propriety of professional accountants advising clients financially on matters which come 'outside' a professional accountant's work, we are a little at a loss to understand what is really intended."

From the chapter on professional secrecy and cases of suspected fraud:

"It would seem that, if an accountant should discover that his employer has made improper returns for the purpose, say, of income-tax assessment, he would not be justified in disclosing the fact (voluntarily) but should treat it with the same secrecy as other matters coming to his knowledge in connection with his employer's affairs. One point, however, is perfectly
clear—he should in any case under such circumstances decline to go on with the work, and should wash his hands of the whole matter, even if this involves losing the fee to which he would have been entitled on the completion of his task; but need he go further?"

Readers of the book will find it to be interesting and well worth while. It was especially interesting to this reviewer in its historical side lights and in the discussions on points in which English practice differs from American practice. It is noteworthy to observe that in all matters in which English practice is analogous to American practice, rules of professional conduct have been adopted by the Institute of Chartered Accountants in England and Wales similar to those which have been promulgated by the American Institute of Accountants.

I unhesitatingly commend the book.

Carl H. Nau,


In Mr. Auld’s informative and perhaps timely book, The Dawes Plan and the New Economics, we have a vivid description of the financial chaos in Europe in 1922–24, caused by the deadlock on the reparations question between the Allies and Germany; an account of the formation, personnel and work of the Dawes Committee; a clear exposition of the Dawes plan which was accepted by all parties to the controversy; and a lively polemic against Professor Keynes and his followers who attempted, and still are trying, to discredit the plan. For the benefit of the layman there is a preliminary chapter explaining in simple language the “mystery” of foreign exchange. The final chapter is rather a curious non sequitur. After having logically refuted the arguments advanced by the Keynes school of “new economics” in favor of canceling the reparations debt, Mr. Auld advocates the cancellation of that and of all other international war debts. This surprising anti-climax seems utterly to destroy the value of the book as a polemic. However, there is meat enough in the rest of the book to make it worth while to readers wishing for a concise bird’s-eye view of the Dawes plan and how it is working out. Mr. Auld was formerly accountant general of the reparations commission and therefore speaks with the authority of one who knows the facts.

We live fast in these days and probably ninety-nine per cent. of the American people have forgotten, if they ever realized, the chaotic state of affairs in Europe in 1922–24. On May 1, 1921, the reparations commission had fixed the German debt at the astronomical figure of 31 billion dollars. Up to December, 1922, Germany had paid 1,200 million dollars, about half of which had gone toward the costs of the armies of occupation. Then Germany asked for a moratorium of three or four years, in which England joined with the additional proposal that 18 billions of the total debt be canceled. France rejected the proposals and occupied the Ruhr (as the commission declared Germany in voluntary default). Germany’s chief industries were paralyzed and the mark began its flight to the bottomless abyss. After two years of hopeless confusion President Coolidge proffered the services of American experts to try to solve the problem. The appointment of the Dawes committee followed in due course. What the committee was authorized to do and what it actually did form a striking parallel to the course followed by the convention which gave us
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our own constitution. The committee was authorized (1) to consider means to balance the German budget and stabilize the currency; and (2) to consider means of estimating the amount of exported capital and of bringing it back to Germany. Not a word about reparations, be it observed! What it did was to accomplish the above objects, and in addition to fix the annual charge for reparations, and, in Mr. Auld's opinion, to fix the total amount of reparations. As a matter of fact the Dawes report carefully avoided fixing any limit whatever, probably because the committee itself was known to be divided on the question. Unable to agree on that point the committee wisely left it for future consideration. The main thing was to get Germany back on her feet financially, start the flow of trade and production, and give France some relief from her burden of taxation.

So far Germany has met the requirements for reparations, viz:

For 1924–25 ....................... 250 million dollars
'' 1925–26 .......................... 305 ''
'' 1926–27 .......................... 375 ''
'' 1927–28 .......................... 437½ ''

With the year beginning September 1, 1928, she is required to pay the standard annuity of 625 millions until 1940, and an additional annuity on railway bonds of 240 millions until 1964. These payments represent 5% interest and 1% for sinking fund, and assuming that there will be no extension of these annuities Mr. Auld estimates, on a 4% basis, that the capital sum of reparations is about 9 billion dollars. The plan also provides for additional increases after 1929 based on a so-called "index of prosperity" in certain kinds of trade, but, as these are purely problematical and speculative, Mr. Auld ignores them.

Such is the Dawes plan in brief, and so far it has worked smoothly, despite the dismal predictions of Germany and the Keynes school every year that "next year" it would fail. We now come to the crucial year of 1928 when the standard annuity of 625 millions will be required. The usual prediction has been made, and is somewhat enhanced by the weighty authority of Dr. Schacht, the president of the reichsbank, who has suddenly become a convert to the new economic theory regarding the transfer of funds across the frontier. Since Germany is required only to pay in marks to the agent general and it is the affair of the allied governments to get them transferred, Dr. Schacht seems needlessly worried! However, as it is plainly only another move in the great game of cancellation his motive is quite discernible. What is important to America, since it vitally affects her future in foreign trade, is this new economic theory by which Professor Keynes and his school of economists attempt to prove the impossibility that reparations, or any other large international debts, will ever be paid at all.

In brief the theory is this:

(a) International debts must be paid either in money (foreign exchange) or in goods (export surplus);
(b) They can not be paid in money without disrupting foreign exchange generally and causing world-wide disaster;
(c) They can not be paid in goods without ruining similar industries of the creditor country, so goods will not be accepted in payment;
(d) Therefore, large international debts can not be paid at all.  Q. E. D.
To these propositions Mr. Auld replies that the flow of natural trade always has and probably always will produce ample foreign exchange. In temporary cases of excessive demand it will be met by new borrowings of capital as here-tofore. The great fallacy of the new economic theory is its assumption that the huge capital sums involved must be met at any one time when all history of funded debts, corporate or governmental, shows that payments of interest and principal are made in a continuous flow of funding and re-funding. As well might the holders of the bonds of our railroads be affrighted by pointing to the stupendous total of them with the alarming warning that there is not enough "money" in the world to pay them!

His chief argument is the actual experience of Europe in the years before the war in collecting interest on foreign debts of 50 billion dollars.

I have said that Mr. Auld's book is "perhaps" timely. A powerful party in Germany has protested regularly every year against paying reparations at all, and it may be that Dr. Schacht's prediction of failure of the Dawes plan this year is merely a habit, and Mr. Auld may be needlessly alarmed. Nevertheless, it is well to note some rather important events of 1927 which lend color to the suspicion that Germany, aided and abetted by the Keynes school of economists, is about to launch a strong drive for cancellation. First, there is the ominous, steadily growing deficit in the German budget to which the agent general calls attention in his report for 1927—a deficit entirely due to swelling governmental expenditures. Here is prima-facie ground for the claim that Germany can not pay reparations. Second, there are the recently published reports of Scandinavian pro-German savants declaring Germany guiltless of provoking the world war, and manifestly the whole theory of reparations is based on Germany's guilt. Third, there is the rather disturbing suggestion of the agent general himself, if he is correctly reported, that the amount of the reparations debt should be finally assessed, the Dawes plan abandoned so far as control over German finances is concerned, and Germany be left to her own devices as to time and manner of payment. Considering these things it is quite possible that there will be a battle over the Dawes plan this year, involving, of course, a revival of the whole war-debt controversy. In that case America's interest in the fate of the Dawes plan is so great that Mr. Auld's book is most timely. Americans are prone to pay great respect to expert opinions uttered by economists of such high standing as Professor Keynes, and it would be well for us to know there is another side to the story. Mr. Auld tells it and tells it most convincingly.

But why did he add that last chapter? 

W. H. LAWTON.


This little book, called *Mechanism of Standard Cost Accounting*, is interesting particularly because of the amount of information which has been packed into its few pages. One familiar with cost accounting of any sort would naturally assume that in a book of this size very little practical information could be given. The author, however, has wasted no time on non-essentials, but has devoted almost the whole of the book to practical discussion and supporting
statements and forms. At the outset, he qualifies the information given by stating that the methods described are "applicable only to factories engaged on repetition or mass production work." This qualification of the subject, of course, enables him to condense the information presented.

After a discussion of the theoretical basis of cost accounting and the introduction of cost formulae, the author defines three common types of standard cost accounting systems as follows:

(1) A system whereunder factory costs, stocks and cost of sales are carried in the books at standard or predetermined values, the variance between standard and actual values being segregated in "Variance accounts."

(2) A system whereunder all figures are recorded in the general books at actual cost but both standard and actual values are carried in the factory books. Under this system the ratios of actual to standard costs are developed by the work-in-progress accounts, these ratios being used to convert from standard to actual cost finished goods put into stores or shipped.

(3) A system which differs from the second system outlined principally in the methods of recording net good production and efficiency data.

Following this general outline, the author describes in detail systems (1) and (2), supporting his descriptions with charts and forms setting forth the methods by which costs are determined, and including pro forma journal entries, balance-sheets, and profit-and-loss accounts.

To the practising accountant who does not specialize in the installation of cost systems, but is occasionally asked to work up new standards for standard cost accounting systems, or would like to own a practical reference book on standard costs, this volume is recommended.

W. B. FRANKE,
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| IX      | Conduct of juniors in clients' offices |
| X       | Absence discovered in clients' offices |
|         | Checking the correctness of the assistant's own work |
|         | Utilising waiting time |
|         | Systematic check-marks |
|         | Care of papers |
|         | Care of clients' books and records |
|         | Reports — Matter to be included |
|         | The style |

First published in book form in February, 1918, this book's popularity has been consistently maintained. It is now in the fourth printing.

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