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# The JOURNAL of ACCOUNTANCY

VOLUME XLIV

AUGUST, 1927

NUMBER 2

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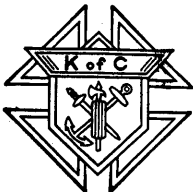
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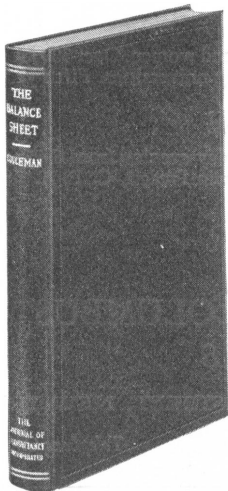
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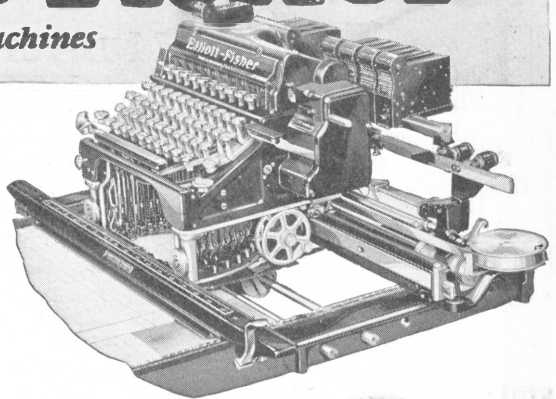
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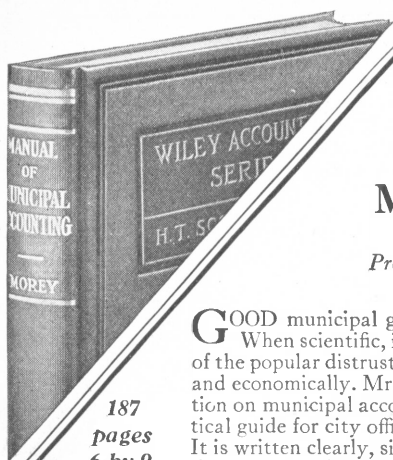
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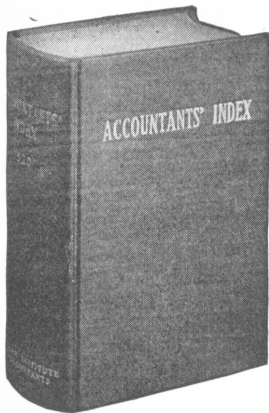
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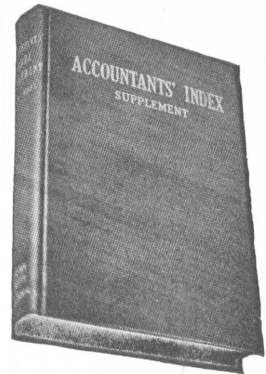
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Vol. 44

AUGUST, 1927

No. 2

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## Audit Procedure and Books of Account in Small Municipalities

BY ROY C. BROWN

The professional accountant who is first called in to audit the records of a small municipality is in nearly every case confronted with a situation involving inadequacy of records, commingling of funds, and a multiplicity of minor inaccuracies. In some instances he will find that no attempt has been made to keep books and that the only records available are the tax rolls, minute book, police docket, stubs or carbon copies of the various classes of tax receipts and statements from banks of deposit with canceled warrants or cheques.

Such a situation is far from hopeless. From the viewpoint of the accountant and excepting the failure of municipal authorities to maintain such records as the law may specifically provide, it is a better condition than the presence of a misfit set of books, the product of the limited ability and knowledge of some local bookkeeper.

One of the first advisable steps is a consultation with the attorney for the municipality. If the attorney is convinced of the helpful intentions and knowledge and professional standing of the accountant, he is likely to divulge in confidence a wealth of useful information as to the personal characteristics of the mayor and aldermen and of the local taxpayers and an informal history of past performances which will be of the greatest assistance in interpreting the facts behind the figures which the accountant will presently examine and compile. The accountant should also at this time take notes of any specific statutory requirements as to the duties of municipal officers, books of record to be kept, how special meetings are to be arranged, limits to bonded indebtedness, limitations as to assessments of taxes for specific purposes, as to fund deposits and depositaries, and application of funds.

Equipped with this valuable information the actual audit procedure can now be intelligently commenced. The first advisable step is to foot the tax rolls to ascertain whether or not the total is in agreement with the amount shown by the minutes of the regular meeting at which the rolls were accepted, and the tax rates, expressed in mills, for each specific purpose authorized. The reconciled total, plus subsequent upward revisions and minus downward revisions as shown by the minutes, multiplied by the total mills, should give a result in agreement with a tape taken from copies of the tax receipts, although such an agreement will usually be found lacking. The deposits of tax money made to the various fund accounts, plus original receipts not delivered to delinquent taxpayers, should agree with the total taxes due to be collected, and the original receipts on hand will afford a schedule of taxpayers who are delinquent.

A very rough proof of the street-tax collections can be made by multiplying the number of qualified voters by the rate per annum in dollars, but, on account of the age at which street tax first becomes due, usually 18 years, and the unfortunate fact that many citizens fail to qualify to exercise the franchise, no significance can be attached to an overrun of the deposits. A smaller collection than the proof figure should be investigated.

Deposits of fines should be proved by inspecting the police docket. Privilege taxes are difficult to prove without a physical checking of the business houses and industries, which is hardly practicable. However, the accountant can usually learn in conversation whether any tent shows or circuses have visited the town in the recent past, and if no stubs are in evidence to show the collection for privilege licence from such visitors an inquiry should be made.

Bank balances should be verified and the bank accounts reconciled as in any audit. Warrants should be compared with the minutes of council to ascertain that all payments have been properly authorized and the authorizations made a matter of record. Invoices against which the warrants have been issued should be called for and examined for approvals and certifications as to receipt, correctness of quantities billed and satisfactory condition and quality of any material received.

Ordinances authorizing sidewalk construction should be particularly examined and a comparison should be made between the bills and the authorized construction. The collection of the

proportion of the expense to be borne by taxpayers directly benefited should be verified.

Bond issues should be traced to the original authorizations. Canceled bonds and coupons or records of their destruction by council at regular or special meetings should be examined and checked against a schedule prepared by the accountant, showing the maturities of bonds and coupons, in order to determine the amount of bonds and coupons that have matured but have not been presented for payment, and this amount should be reconciled with the balances in special bond-redemption accounts in the possession of banks or trustees designated to pay maturing bonds and coupons on presentation.

Realizations from the sale of bonds should be verified, and, with the application of the bond funds, should be made the subject of a schedule for each bond issue.

If the town owns and operates a light or water plant, the actual construction cost will have been verified in the comparison of the warrants with the minutes. Contracts for work in the erection of the plant, construction of the distribution system and installation of the machinery should also be examined and the accountant should at least visit the plant and verify the installation of engines, electrical machinery, pumps, tanks, etc. Care should be taken to ascertain that insurance coverage in the form of fire, tornado, employers' and public liability and electrical-machinery policies have been provided and are on file, as well as steam-boiler insurance if the plant has one or more steam boilers in the equipment. The machinery houses should be circularized to learn whether vendors' liens exist on any of the machinery or not.

The existence of a good light and water register divided according to sections of the city, as is the tax roll, showing where revenue is due to be collected and the names of consumers in arrears will rarely be found. Designing and installing such a register will be one of the accountant's most valuable services. An ordinary columnar book can be used to advantage. Only one section should be listed in each block of five lines, and four columns to the month may be used conveniently, the first to record current and previous meter readings, the second to extend the amount due for light and power, the third for the amount due for water, and the fourth to record the date when each account is paid.

Surety bonds should be called for and inspected, and if recent inventories of miscellaneous equipment such as fire hose, hose

carts, wagons, harness, live stock, tractors, road machinery, sprinkler wagons, etc., are not available the accountant should request that an inventory be made, in order that such assets may be properly valued and listed on the books of account.

When the work has progressed to this point, it becomes necessary to consider what books of account should be installed to prepare a workable chart of accounts, and to begin the preparation of a report for presentation to the board of mayor and aldermen. The following books will usually be found sufficient:

1. Collection register (columnar stock form).
2. Warrant register (columnar stock form).
3. Light and water register (columnar stock form).
4. General journal (stock form).
5. General ledger (stock form).

No provision is made for a payroll book, as each department will carry stock-form time books if the number of employees warrants it.

In the preparation of a chart of accounts nice discriminations must be observed, in order that the designated accounts may accord with good practice and at the same time be not so technical as to confuse the people interested. The average small-town taxpayer takes a much more active interest in the affairs of his municipality than a resident of a larger community, where interest is apt to be casual and perfunctory if it exists at all. The accounts and distribution system must be readily comprehensible to the clerk, who often devotes only a part of his time to the affairs of the town, and statements drawn from the books must be readily understandable to the board of mayor and aldermen and to taxpayers who may, and many of whom will, care to inspect the record.

Such terminology as "budget requirements", "special revenue requirements", "construction requirements", "reserve for capital claims", etc., will be Greek to the ordinary citizen, and he will usually be outspoken in disapproval of the employment of such language in the description of the affairs of his municipality, about which he very properly feels that he is entitled to information which he can understand at a glance. Bearing this in mind, the following classification is suggested as a practical one, subject to revision to meet local conditions.

*Municipal Audit Procedure and Books of Account*

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*Assets*

Current assets:

101. General fund (bank account).
102. Street fund (bank account).
103. Light and water fund (bank account).
104. Taxes receivable, current year.
105. Taxes receivable, previous years.
106. Light and water accounts receivable.
107. Special assessments receivable, current year.
108. Special assessments receivable, previous years.
120. Other current items.

Parks and public buildings:

201. Town hall and jail, including sites.
202. Parks and pavilions.

Streets, driveways, sidewalks, and sewers:

301. Paved streets, concrete.
302. Paved streets, brick.
303. Paved streets, bitulithic and other construction.
304. Sidewalks, concrete.
305. Sidewalks, brick.
306. Sidewalks, other construction.
307. Sanitary sewerage system.

Public utility, income producing:

401. Light and water plant buildings and sites.
402. Engines.
403. Electrical machinery.
404. Pumps.
405. Boilers.
406. Fuel storage tanks.
407. Fuel storage bins.
408. Water tanks and towers.
409. Artesian wells.
410. Light and power distribution system, poles, wires, etc.
411. Meters, electric.
412. Water mains.
413. Water lines.
414. Meters, water.

Other properties:

501. Hose carts and fire apparatus.
502. Fire hose.



- 503. Sprinkler wagons.
- 504. Trash and other wagons and carts.
- 505. Work animals.
- 506. Fire and hose-cart houses.
- 507. Tractors.
- 508. Road-working machinery.
- 509. Office furniture and equipment.
- 520. Miscellaneous equipment.

**Bond and special funds:**

List unexpended balances in each bond fund or special fund, only available for definite construction projects, prefixing each account with a number, beginning with 601.

**Current liabilities:** *Liabilities*

- 801. Salaries payable.
- 802. Payrolls payable.
- 803. Accounts payable, approved.
- 804. Notes payable.
- 805. Current maturities, bonds and coupons.
- 806. Claims admitted, tax refunds and damages.
- 807. Judgments payable.
- 820. Other current items.

**Bonded indebtedness:**

List each outstanding issue, prefixing the first item 1001 and so on.

**Surplus:**

- 1101. Current surplus, excess of current assets over current liabilities.
- 1102. Capital surplus, excess of other assets over bonded indebtedness.

*Revenues*

- 1201. Taxes, general levy.
- 1202. Taxes, bond and coupon levy.
- 1203. Privilege licences.
- 1204. Street taxes.
- 1205. Fines and costs.
- 1206. County settlements.
- 1207. Sales, light and power.
- 1208. Sales, water.
- 1220. Miscellaneous.

*Expenses*

- 1301. Salaries, mayor and clerk.
- 1302. Stationery and office supplies.
- 1303. Telephone and telegraph.
- 1304. Rent.
- 1305. Heat, light, janitor.
- 1306. Salary, marshal and watchmen.
- 1307. Sprinkling and cleaning streets, labor.
- 1308. Sprinkling and cleaning streets, material.
- 1309. Repairs, streets, sewers and sidewalks.
- 1310. Light and water plant, salary of superintendent.
- 1311. " " " " wages.
- 1312. " " " " fuel.
- 1313. " " " " lubricating oil.
- 1314. " " " " repairs machinery.
- 1315. " " " " repairs structures.
- 1316. " " " " repairs transmission lines, electric.
- 1317. " " " " repairs mains.
- 1318. " " " " repairs water lines.
- 1319. " " " " supplies.
- 1320. " " " " insurance.
- 1321. " " " " miscellaneous.
- 1330. Personal injuries.
- 1331. Taxes refunded.
- 1332. Interest, notes payable.
- 1333. Interest, bond coupons.
- 1334. Fire and storm damage.
- 1335. Charitable expenditures.
- 1350. Miscellaneous.

The preparation of the report, especially the first report which will excite unusual interest, curiosity and comment, calls for tactful treatment. Errors of omission and commission should be commented on, but with care to avoid severity in treatment. The advantages of preparing an annual budget and operating within its limits should be emphasized. The balance-sheet should be explained, item by item, as in a commercial audit. The complimentary closing should be cordial, but care should be taken not to overdo this, as excessive cordiality may easily strike a note of insincerity.

Suggested exhibits and schedules to accompany the report are:

- Exhibit "A." Balance-sheet.
- Exhibit "B." Cash receipts and disbursements.
- Exhibit "C." Bond-fund expenditures.
- Exhibit "D." Light and water operating statement.
- Schedule 1. Delinquent taxes.
  - " 2. Delinquent light and water accounts.
  - " 3. Public-utility properties, income producing.
  - " 4. Salaries payable.
  - " 5. Accounts payable.
  - " 6. Notes payable.
  - " 7. Bonded indebtedness.
  - " 8. Reconciliation current surplus.
  - " 9. Reconciliation capital surplus.

Auditing small-town records is a very unfruitful field for specialization. The fees are usually meager, working conditions poor and the work is laborious in the extreme. Nevertheless, there is an increasing tendency for legislatures to require publication of annual balance-sheets and statements of receipts and disbursements by towns of 1,000 population and over, and it is one of the conditions that the profession must meet unselfishly and with convincing thoroughness. If there are any rewards to be expected they will be in the form of goodwill and such accretions to practices as may result from the formation of new friendships and acquaintances. In the hope that the subject matter may be in some small way helpful, this article has been prepared and offered for publication in *THE JOURNAL OF ACCOUNTANCY*.

The undeniable factor of depreciation of the properties has purposely been left untouched in the article. The good judgment of the accountant will enable him to determine whether it is practicable to recognize depreciation on the books of account or preferable to ignore it. The question has been the subject of much controversy, with the proponents of bringing depreciation on the books usually having quite the better of the argument. It is sufficient to say that occasionally a stone wall will be found most illogically placed and no arguments, however sound, or theories, however tenable, will move it.

# The Return Earned by Private Industries and Public Utilities\*

BY RAYMOND EDWARD NORTH

## I

Despite the ever growing complexity of business and commercial intercourse, with its seeming confusion, the profit motive remains the principal stimulus. Men engage their capital and ability in industry primarily with the hope of pecuniary reward, and if their quest is unsuccessful they either voluntarily withdraw or else that which they have is taken from them. If successful, they are entitled to the fruits of their labor. The right to the enjoyment of private property is guaranteed in the federal constitution and forms a cornerstone in our social structure. All industry, whatever its reaction to prosperity or adversity, is concerned first, last and always with the return it can expect to earn upon the value of the investment which has been engaged in the business.

One group of the privately owned industries has become known as the public-utility group because of special characteristics which are peculiar to that industry. A utility is engaged in producing and rendering an "essential service," but that alone does not distinguish it from a so-called industrial. The steel manufacturer, the coal-mining operator, the furniture manufacturer, the owner of a patent for a universally required invention, the clothing manufacturer and the building contractor are all producers of things essentially necessary. Yet their products are not said to be "effected with a public interest" as in the case of utilities. The telephone, water, gas, transportation and electric companies have the additional and distinguishing characteristic of exercising a monopoly within a given territory. The residents of a modern city have no choice from whom they shall take electric or telephone service. On the other hand, while clothing may be just as essential as gas for the evening meal, each person has the widest latitude in the choice of the shop he will patronize, the price he cares to pay and the style of clothing he thinks will become him. If there is to be one utility company, rendering one service to one

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\*An address delivered at a meeting of the Maryland Association of Certified Public Accountants.

group of customers, it is only equitable that one price be charged to all, that there be no discrimination between customers, and that whatever the price may be, it be not excessive or unreasonable. When there is also considered the fact that these public-service companies occupy, use and enjoy the public highways and have the right of eminent domain, the need for some method of regulation as a guard against undue self interest is clearly apparent. So it is, then, that while the purpose of the industrial and the utility is identical, i. e., to supply something desired by people, for a return over and above cost, the method of controlling the return to each is entirely different.

The history of public-service enterprises roughly covers a period of one hundred years. The gas industry is one of the oldest of the group, dating as it does in America from the opening of the nineteenth century. The telephone was yet an experiment when Alexander Graham Bell exhibited it at the Centennial celebration in Philadelphia in 1876. Edison's pioneering work in the electrical industry was becoming fruitful at the same time, for in 1882 the first central station was built in the city of New York. Steam transportation had been proven practicable as early as the third decade of the nineteenth century. The early utility enterprises were treated as any new industrial enterprise would be treated today. That is to say the field was open to all comers for such exploitation as they cared to undertake. A general struggle for existence ensued, generally to the dissatisfaction of the public. Discrimination was prevalent. Rate wars succeeded one another in a regular order. The dominant company in each territory either forced the weaker companies out of business or bought them out. And at all times there was a constant danger that the streets would be torn up by some new competitor, often with the purpose of forcing the existing companies to remove the threat at a handsome profit to the promoter. After a protracted period of such unrestricted competition, detrimental to the public and to the utilities themselves, one company generally survived in each locality. The practice of commission regulation, delegated with authority by the state legislature, was then evolved. This development came with the twentieth century as an acceptable contribution to social progress and commercial growth. Utility regulation has been adequately tested during the last fifteen or twenty years, and where undesirable influences have been absent the results have been salutary.

## II

Although industrial enterprises are ostensibly uncontrolled, they are nevertheless regulated through the operation of natural laws and the free interplay of economic forces. The return to one such industry is not limited as to amount, but it is directly dependent upon managerial skill and ability. Competition serves to fix the selling price for similar ventures while the skill with which a particular company is operated largely determines the cost of production and hence the spread between the two—or the return to that company. Capital and ability naturally tend to flow into the most profitable fields. As the influx continues, competition becomes keener, a larger supply is created and unless the demand can likewise be enlarged, prices will recede. An industrial will gain or lose, probably succeed or fail, as it can create and sustain a demand for its product and supply that demand at a cost under the selling price. The successful company is therefore the one which can maintain or reduce the cost of production at or below the average cost for its class. If the industry continues to afford returns higher than other industries with comparable risks, there will be an accession of new competitors to the ranks. Prices will gradually become lower, approaching the average cost of production as the limit. The spread between cost and selling price is gradually lessened as the field is developed. The marginal producer is then the first to be forced out. He must offer his goods at the current quotation in order to sell them at all, but he finds that his higher production costs make his continued operations unprofitable. He therefore quits, either voluntarily or involuntarily. As the influx of competitors continues or the available supply exceeds the present demand the less efficient producers will continue to be eliminated and only the more efficient will survive. Later, if a greater demand develops or if capital is withdrawn from the industry, so that the return to those remaining would again become larger than to other industries attended by similar risks, accessions to the ranks will begin and the cycle will be repeated. It can be seen that the supply-and-demand law regulates selling prices, but that cost of production determines the return to the industrial and its success. This is another way of saying that the return an industrial gets depends upon the skill and ability of the management. If the cost for a company is equal to the average for its class, the return will be an average

return. If the cost is below the average, the company so situated will enjoy a higher return. There is no limit to what it can earn.

An increase in business and profits is more surely obtained by lessening the cost of production than by increasing the selling price. An increase in the selling price may produce, not more income, but less income. The management of an industrial should prefer to sell one thousand units at a profit of ten cents rather than five hundred units at a profit of fifteen or eighteen cents. Suppose that an increase in the output of five hundred units would throw a greater supply on the market than the normal demand would sustain. In that event a new demand must be stimulated or else intensive sales efforts must be used to capture the customers of competing companies. In either event the most satisfactory way to induce the additional purchases is to reduce the sales price. But if the added business is to be profitable, or, better, if the whole volume is to be proportionally more profitable, the cost of production must also be reduced. Often the very fact of the greater output will alone reduce costs, since the indirect charges, such as supervision, depreciation, insurance, taxes and repairs may not increase as the direct charges for material and labor do. The success of the United States Steel Company or the Ford Motor Company and the satisfactory return which each earns are due largely to their low operating costs, made possible by mass production and able management. In the final analysis then, the question whether or not an industrial can earn a return greater than the average for its class is determined by whether or not it can produce the commodity or service at a cost lower than the average. The management of private industry has a great inducement (if, indeed, it is not a compelling force) to reduce the cost of production as the most effective means of increasing profit. And with the benefit of greater profit to the producer, there invariably goes the benefit of lower prices to the consumer. Prices are not fixed arbitrarily at this or that level, all that has been claimed about combinations in restraint of trade to the contrary notwithstanding.

This discussion does not overlook the occasions when returns or profits are independent of production costs. In a seller's market when prices are rapidly rising—rising more rapidly than costs—and a general wave of prosperity is being enjoyed, the return is accordingly increased. The larger return, which may be considered as consisting of two elements, (a) the normal return

incident to the industry and (b) profit due to extraordinary conditions, is predicated upon the excessive demand as distinguished from individual operating efficiency. Conversely, during an unsupported buyer's market, when prices may drop below production cost, losses are incurred which the most able management can not avoid. Again, this discussion does not overlook the large gains made possible by discovery of new natural resources—gains that may be unrelated to the cost of development. But these conditions are usually temporary. At least they are exceptional. The tendency of prices to approach cost of production is a long-time tendency. And the statement that cost of production finally determines return applies to general conditions over a period of years. Within an industry during periods of rapidly rising or falling prices, the low cost producer always earns the greatest return. Ordinarily there is no criticism when an industrial earns an excessive return, or profits, even when these profits accrue from a combination of circumstances not brought about by the industry and over which it has no control. The reason for this is simply that at a later date the industrial may suffer a deficient return, or losses, due also to conditions over which it has no control. The possibility of gain is offset by the hazard of losses. In the long run private industry is forced to its best effort in order to survive.

### III

Contrasted with the natural forces operating to regulate the return to industrials is the more artificial commission form of regulation that has been developed in the utility field. The necessity for commission regulation is no longer debatable. It strongly appears that regulation is here to stay and enough experience has been had to remove it from the realm of experiment. The principles of utility valuation and rate making have become well settled. It is pertinent to inquire whether commission regulation in any way may destroy the incentive of utility management, so forcefully preserved in the other great group of privately owned industries—the so-called industrials.

Prices charged for service by utilities are composed of two factors: (a) the cost of the service and (b) a return to the utility. The costs of operation include manufacturing or generating costs, such as fuel, labor, oil, supplies and maintenance, plus commercial, general and administrative costs, taxes and an allowance for



property retirements. The return, or that part of the rate to which the owners are entitled, is measured as to its adequacy by its relation to the fair value of the property used and useful in the public service. Utilities generally have the right to establish service rates themselves, subject to the approval of the public-service commission.

Rates are not established at what the service is intrinsically worth, for obviously the pure subjective value of an essential service—water in the home, for instance—is incomparably great. In the first instance, rates may be fixed at what the traffic will bear. In some cases rates may be prescribed by public opinion. For instance, some street-railway companies do not earn a return as liberal as the local commission would permit, simply because public opinion has associated the five-cent fare with surface electric lines for so many years that a higher fare is difficult to obtain. The same prejudice undoubtedly works against gas companies in some cities. There is less opposition to electric and telephone company rate revisions in the opinion of John Moody, the investment analyst. An inquiry to determine the fairness of a rate is necessarily a process of the application of arbitrary (i. e., discretionary as against natural) methods.

Public-service commissions have no formula for arriving at rates or approving those previously established, except merely to indicate the lower and upper levels between which the rate should fall. A rate should not be fixed at a point so low that the income produced will be inadequate to meet the cost of production plus a compensation to the owners for the use of their property. This is the lower level—the point of confiscation. The owners of public utilities have ample protection against that contingency in the provision of the federal constitution protecting property from confiscation—a provision the courts have never hesitated to enforce. The upper level is more vaguely described as that point where a given rate will become unreasonable and unduly excessive or simply that point where the rate is greater than the value of the service to the customer. The precise determination of the point between these two extremes for fixing a fair rate constitutes the main function of the regulatory commission. Ordinarily, there is a wide range within which the commission may exercise its judgment. The general rule remains that a rate must be reasonable to the company and to the customer. Of the two, reasonableness to the customer is paramount. Neither of these limits

is a test of the fairness of a rate. That is, if a utility finds that the income it is receiving does not permit a fair return, it will not be justified in increasing the rate solely because the increased rate would not be unreasonable or more than the worth of the service. On the other hand the utility could not be denied the increase solely upon evidence that the present rate is not confiscatory. These are but the extremes—the non-compensatory rate, the extreme to which the utility may suffer without intervention of the court, and the excessive rate, the extreme to which the customer may suffer in any circumstances.

If we assume that utility management is honest, the portion of the rate to recover operating expenses is reduced to a question of measurement. The utility will report and disclose the cost of rendering service, such amount will represent a dollar for dollar recovery and there will be nothing included in the cost for return or profit. The amount of the return and the percentage it bears to the property value will vary from year to year and become the index for measuring the fairness of the rate. A most important question in public-utility economics concerns the position the commissions are going to take with respect to the return. Among the industrials, return is virtually the reward for skill and ability. The characteristics which distinguish the utilities from all other private enterprises do not distinguish them on this point. Whatever return they earn is or should be the reward for skill and ability. Our present system of regulation may result in the stagnation of initiative and managerial zeal if sound policies are not evolved.

#### IV

There is a mistaken idea among some people that a return to the owners of public utilities may be held stationary, or nearly so, without causing disturbance in any other factor of an intricate and sensitive arrangement. An attempt to maintain a fixed rate of return, e. g., a return that shall always be equivalent to 7 per cent. on the fair value of property, could ultimately have but one effect. Managerial zeal and efficiency would be discouraged, if not stifled. The owners of such a utility then become virtually mere annuitants of their property lulled into a state of complacency without definite assurances that they can always earn as much and without hope of earning more than the prescribed return. There would be no change in the result whether the

fixed rate of return were a high return, a low return or an average return, if any improvement in operating conditions were the signal for a reduction in rates to bring the utility back to the previous level. If the permitted return were liberal there would be a strong inducement for the utility to become extravagant. It would not feel the urge to operate in the most economical manner because reductions in the cost of production would increase the already liberal return and precipitate a rate investigation. Liberal rates of return are not the fashion, however. They are the goal in a great many cases and not the attainment of the utility. If the return were just a normal one, again, the mere prospect that there would be no reward for more efficient service would discourage managerial incentive. And of course if the return were less than normal there would be more inducement to seek higher rates for service than to reduce operating costs.

It is submitted as a sound proposition that commission regulation should use every possible means to preserve and encourage the best efforts of private owners and managers of public utilities toward reduction of operating costs to an irreducible minimum. The most satisfactory way to stimulate such effort is to permit the owners to share the results. Regulation can not accomplish by fiat for the consumers of utilities what natural laws accomplish for the consumers of industrial products. If commissions adopt the "penny wise, pound foolish" policy of strictly limiting returns, the public can not consistently expect the best sort of service at the lowest prices. A policy of regulation which does not recognize or promote economy in all things places a premium upon extravagance in all things. Many of the war-time governmental building contracts were made on a basis of cost plus 10 per cent. profit. The effect was to encourage extravagant and unnecessary expenditures, for the greater the cost, the greater the profit. When dealing with the utilities the wisest policy would seem to be the lower the cost the greater the profit that will be permitted. Technically, it can be said that a utility does not make a profit—it earns a compensation for the use of property—when profits are taken to mean unrestricted gains due to changing relations between supply and demand. But if there is no hope of increasing its compensation to reward a bettered service, what likelihood is there that the utility will give the best service that it can? The cost of this service will be relatively and actually higher. While the utility may not net more money as

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expenses increase it does recover those expenses, but the consumer pays more to get less.

If a given rate were set at a given time and in given circumstances, that rate might be fair to the public and to the company. Thereafter intensive efforts to obtain more business, vigilance in conducting operations, prudence in making extensions, plus or minus factors over which the utility has no control (such as general variations in the business cycle), might produce a greater return than the given rate was intended at first to yield. Now, to reduce the rates charged so as to bring the return back to the same percentage of the property (which simply means that the consumer gets all the benefit and the utility none of the benefit) is manifestly unfair. This would remove all incentive to further betterment, as it is contrary to elementary human experience to expect people to do their work with zeal when there is no hope for reward. The consumer profits temporarily only, because he can not expect more golden eggs after the goose has been killed. The utility will continue to serve its patrons even under such conditions, just as a slave might continue to serve his master because circumstances do not afford him any alternative. The capital already invested in the utility can not easily be withdrawn and may be obliged to accept a hopeless future. But additional capital can not be forced into the enterprise.

Enlightened regulation will see that the best policy in the long run is to encourage utilities to get the most by giving the most; that while the utility may not expect profits in the sense of excessive returns, it may expect to share in the benefits effected through wise, careful and economical management. It should be remembered that utilities never are guaranteed any return. It is to be had only if it can be earned and the return it does earn arises from the utility's own effort. Many people have the false conception that because commission regulation may permit a certain return if it can be earned the commission guarantees that return at all times to the utility. The chief difference between the return of an industrial and that of a utility is that the latter should fluctuate within much narrower limits. Both are privately owned and both should be entitled to just reward for their efforts. With the industrial the reward is predicated finally upon the skill and ability of the management. There should be no discrimination against utilities on this point simply because discretionary regulation has largely replaced natural laws in the public-service field.

V

When the utility is not hampered, but induced to conduct itself in the most efficient manner, two results may be expected: (1) the lowest rate for the best service, which is the consumers' primary interest, and (2) a return favorably comparable to that earned by similar undertakings under similar conditions, which is the utility's primary interest. A utility thus situated should enjoy the highest credit, so that the large amounts of new capital which are required for plant extensions may be obtained at the lowest cost. The borrowed money will then require smaller interest payments and consequently make the return still more effective to the stockholders. From this reference to the cost of money the inference should not be drawn that the amount of the interest and dividend payments is any measure of the adequacy of the return. Such reasoning would lead one in a circle. Whatever return the utility earns represents all the compensation it gets. That amount belongs to the utility and may be disbursed or retained as discretion requires.

For some reason 6 per cent. has been generally considered a fair return. It is necessary to break away from the fetish of arbitrarily associating 6 per cent. with fairness and more than 6 per cent. with usury. There is no sound basis for such a standard, reducing as it does all utilities to a common level, where the able are penalized and the weak subsidized. An arbitrary rate of return may be fixed in the first instance, whether the commission has before it a new company or a going company whose property has not theretofore been valued. What shall this return be? The special master in the case of *Consolidated Gas Company of New York v. Prendergast*, decided by the United States district court in 1925, determined the rate of return from these questions: "If the investors were going to buy or build a property like that of the complainant, what amount would they feel that the property should earn in order to induce them to invest their money in the purchase or construction of such a property? Taking into consideration other classes of investment in this locality, with the comparative risks and return thereon, the rate of return generally required to secure proper credit for borrowing money and financing its operations, what should a utility company subject to state regulation be permitted to earn in order that it might compete successfully with other businesses and be on a parity with them?"

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In this case the special master decided that 8 per cent. was a fair rate of return. Both the patrons and the utility could rest their cases upon the correct answers to those two questions.

It is contended, however, that a further provision is needed unless rate litigation is to be a continuous affair. The further provision should be a recognition, whether expressly stated or followed as a fact, by the regulatory body that savings will be divided between the utility, in the form of enlarged return, and the public, in the form of lowered rates. One public-service commission has recently passed an order providing that for each five-cent reduction in rates to the consumers, the utility at the same time will be entitled to a return  $\frac{1}{2}$  of 1 per cent. greater. That is a definite and real spur to efficient operation which no alert management would overlook, except at its own expense. While the order did not say what would happen if rates were increased, it is to be presumed that some adjustment would be made in the return at that time also, especially if previously the return had been increased when rates were lowered. Rate increases as a rule are generally obtained long after they are needed and it is quite probable that the return remains low even after such increase.

The transportation act of 1920 provides for a varying percentage return on the property of railroads. The act fixed the fair return for 1920 and 1921 at  $5\frac{1}{2}$  per cent. plus an additional  $\frac{1}{2}$  of 1 per cent. in the discretion of the interstate commerce commission. Railroad rates are uniform within a rate group or territory, so that strong roads will earn more than weak roads at the same rates. The act accordingly provides that one half of the excess over the prescribed return may be retained by the carrier and that the other half shall be paid into a government fund to assist the weaker roads. It is true that these recapture clauses are the result of competition between strong and weak railroads—a competition absent among other utilities. But they serve to illustrate the essential fairness of a provision that does not restrict all companies to a minimum fair return or to any fixed maximum percentage return, but establishes an average fair return plus one half of the excess actually earned, however large that excess may be. The supreme court in the *Dayton-Goose Creek* case (263 U. S.) said: "Uniform rates enjoined for all shippers will tend to divide the business in proper proportion so that, when the burden is great, the railroad of each carrier will be used to its capacity. If the weaker roads were permitted to charge higher rates than

their competitors, the business would seek the stronger roads with the lower rates and congestion would follow. The directions given to the commission in fixing uniform rates will tend to put them on a scale enabling a railroad of average efficiency among all the carriers of the section to earn the prescribed maximum return. Those who earn more must hold one half of the excess primarily to preserve their sound economic condition and avoid wasteful expenditures and unwise dividends. Those who earn less are to be given help by credit secured through a fund made up of the other half of the excess. By the recapture clauses congress is enabled to maintain uniform rates for all shippers and yet keep the net returns of railways, whether strong or weak, to the *varying percentages which are fair respectively for them.*" (Italics supplied.) The Dayton-Goose Creek Railway had earned a return of 8 per cent. after paying over the required one half of excess earnings for the year. There is no necessity for recapture of utility earnings (except those of railroads) since there is no competition. But the principle of varying percentages of return which will be respectively fair for different companies is desirable.

## VI

In a few words the burden of the foregoing is that industrial managers have a positive inducement, if not a compelling force, to produce cheaply and efficiently; that the most efficient are rewarded with the largest returns, and that precisely the same condition should be fostered by regulatory commissions for utilities in the absence of natural laws. Unless utilities are permitted to share in their own economies, then unusual skill, efficiency or economy in management becomes a hazard and hence a real detriment to the utility, since the minimum return is predicated upon continued exceptional skill. The best way to encourage incentive and enterprise, it is believed, is to hold out to the utility the possibility of a larger return. If increases in the return are predicated upon reductions in the rate for service the nearest approach will have been made to the natural situation which governs the industrials. There have been several plans devised to accomplish this purpose. It is far more important that the public-service commission intelligently engage in the *practice* of a varying percentage return, than that any one plan be adopted. The so-called London sliding scale has been tried in England. Charles S. Morgan, in his book, *Regulation and Management of Public*

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*Utilities*, states that the plan has never become of wide application in this country. In a word, it is a plan of adjusting dividends to the stockholders with prices to the public. That is, increased rates are accompanied by decreased dividend payments and vice versa. The essential thing is, to repeat again what has been re-echoed throughout this paper, that regulation is based on the exercise of discretionary methods, that the primary motive in all business is the hope of reward, and, hence, that a very important part of the commission's function should be encouragement of that hope. After all, so far as the return is concerned there is no difference between industrials and utilities as privately owned industries. The average return to one must be in the long run substantially the same as the average return to the other, after allowing for attending risks. Capital will flow where the return is the highest, and utilities, since they constantly require capital, must be assured a return which will attract that capital. The return, if it depends upon managerial skill and ability, as is true with the industrials, will be a varying percentage, and it will be a very good measure by which to judge separate companies.



## Educational Requirements of the Practising Public Accountant

BY W. H. MATHER

The educational requirements of the practising public accountant have been discussed so often in the pages of *THE JOURNAL OF ACCOUNTANCY* that one is forced to realize a recognition of general educational deficiency among the membership of the profession by accountants whose standards are above the average and whose ideals have continued to flourish in spite of the mental inertia of the majority which tends to produce a low normality. But there is hope for great improvement so long as the subject is kept before the attention of accountants, and so long as an ever progressing standard of excellence is the individual aim of those whose position in the profession confers upon them the privilege of setting and maintaining such standards. The precepts of an education are of little moral importance compared with the example of the educator.

So far, the various papers on this subject have failed to give with any cogency of presentation a curriculum differing to any appreciable extent from the curricula of our high schools and colleges whose avowed endeavor is to teach boys how to study and to prepare them for solving the problems of life. This fact seems to prove that the courses of study so outlined are, after all has been said, not so far from the mark as to require any drastic changes.

At the present time our colleges offer three well known courses of study, and because they offer these courses the preparation of students hoping to enter our colleges and universities is strictly within college requirements. Specialization now begins with the high school and not with post-graduate studies. The results do not satisfy our conception of a general or liberal education, but they do satisfy, in theory at least, our conception of specialized training. These three avenues to three distinct types of education are the classical, the scientific and the commercial. The first of these is undoubtedly the most liberal for it can not be said that it fits a man for any specific occupation in the world of affairs. The second is much more objective in its content and much less speculative in its operation, but at the present time ranks much

higher than the classical course in its popularity and attracts the brightest and most serious students. The third is the youngest, and consequently the most "dollarized." In other words, it is the least liberal of the three. Indeed, it can hardly be said to lay any claim to liberal training at all. The student who hopes for college training in commercial subjects has no time or inclination for classical or scientific subjects. His studies are, if he is to specialize in accounting, the ordinary commercial high-school subjects, and a more extended course in the same subjects during his college career. Modern languages have their innings, of course, but the study of the mother tongue and the use of it as based upon the Anglo-Saxon, the Greek and the Latin is an unknown well of useful knowledge. The modern attitude is summed up in the cant, "He knows his stuff." The commercial world wants the man who "knows his stuff."

It is in this atmosphere that many of our young men live and move and have their being. Speed, specialization and earning power are the controlling forces in the preparation for and the realization of a commercial life. With such forces to combat it is almost impossible to inculcate the respect for a broad education which the older generations have learned to value above all other.

From another point of view, the social one, we reach somewhat the same conclusion in a different way. Our well founded claim to the vast opportunities, which our new society affords in contrast with the stratified condition of the social structure of the old world, makes possible the admission into the profession of those men who if judged by social and educational standards would be barred from entrance. The apprenticeship system of the old world requires the passing of an academic examination, the payment of a stiff fee to the employer and a series of technical examinations, all of which cover a period of from five to seven years before the candidate may hope to practise. These requirements establish a social limit for each candidate, with the result that the young articled clerk generally comes from a home surrounded by the comforts of life and all that they mean socially and educationally.

Contrast this condition with that surrounding the ambitious young man in one of our American cities, who works all day, and at night tries to concentrate on the problems of a correspondence-school course in accountancy, whose social status is of no benefit to him, whose education has been fitful, and whose home influences

have left him untouched culturally. This man can not compete educationally with the educated man, yet, in many instances, he competes with him professionally with much success.

The real question, instead of being what education shall the accountant be given, should rather be, what accountant shall be educated? That, of course, leaves the matter with the accountant, and resolves the question into the theory that no amount of education will penetrate the armor-like resistance of many people to cultural development. They are simply not the right soil for this kind of seed. Our schools and colleges have been going on the principle of mass production. They believe that by attending college classes a man must absorb some of the knowledge showered upon him. Probably so, but in too many cases the little knowledge absorbed is not worth the expense incurred in its dissemination. An education is a gift. The word means a drawing out. The conclusion is obvious. It is indeed, therefore, hopeless to expect that all accountants should be educated, at least under the present educational methods. It is also hopeless to imagine that the ordinary client will stop to differentiate between the educated and the uneducated.

The fault, however, lies not with the uneducated accountant but with the standard of the accounting profession. The uneducated man can not create the ideal condition, nor can he realize it. The ideals of any profession are conceived and published by the rare souls who are more often misunderstood than appreciated. If one built a barrier of ideals around the accounting profession there is ample evidence that the unimaginative mind would seize upon the thought that the few wished to gather to themselves the entire benefits and to erect an obstruction which they alone could surmount. That, of course, is the matter in a nutshell. Excellence in any profession demands exclusion. It is the fault of the profession if undesirables are taken into the fold. Despite what the undesirables think, however, they should not be admitted to the profession if the standard of the profession is to rise concomitantly with its importance. The importance of any profession comes not from the layman but from the members of the profession itself, provided always that they be important men with important ideas. The accounting profession is not so young that it need be afraid to take itself more seriously. There are many so-called professions of much later date and doubtful ancestry whose arrogance is equaled only by that of the parvenu. The

accountancy profession in this country has simply failed to assert itself. Under such conditions it is very difficult to keep out the undesirables. There are too many back doors through which they may enter.

It may be admitted, however, that the practising public accountant relies for success on his technical knowledge, and that no amount of history, chemistry, Greek or economics will compensate for any deficiency in this requirement. The public, first and last, comes into contact with the technical man and will not condemn him even if he can not spell correctly. The fact of the matter is that academic excellence is an abstraction as far beyond the ken of the ordinary business man as the abstraction of the "second intention" which has been defined as "A chimera buzzing around in a vacuum seeking what it may devour." No profession may hope for support among the hardheads. It must assume for its own good the dignity of its highest ideals. Therefore, in admitting the lowest type of successful candidate, that is, technical strength coupled with cultural weakness, the profession lowers its morale and must be content with a diluted esprit de corps. But the educationally deficient accountant who is judged by the highest standard of his profession is hardly to blame if he can not see the personal advantages of a good academic training. He is even less to blame if he has failed to develop under the influences of a good education.

High-school training, not the specialized courses, is the least that should be accepted by the accounting profession as the essential academic preparation. There is nothing in the work of the accountant that the high-school graduate can not be taught to do. If, however, individuals seek a broader outlook upon life through the advantages to be derived from a higher education, it does not necessarily follow that they are better accountants because of it. Nor does it follow that a highly specialized business course for the eight years of high school and college training will fit the candidate for the work of the accountant. Some men succeed in spite of their education; others succeed without any education. But, with or without cultural training, the great essential for success in the profession of public accounting is aptitude. That word, given the necessary intellectual quotient, means patience, analytical ability, tact and moral stamina. There are too many candidates who are not accountants, whose admission to and continuance in the profession is an egregious blunder. How to

prevent such blunders is the problem involved in all discussions of educational and natural fitness.

The writer can not hope to answer the question, but his having devoted many years to the teaching profession and his being a practising public accountant make possible the supposition that his observations and conclusions may be of some help. It is generally the understanding of high-school students that the commercial course is a "snap." The ranks are filled from those who have aspired to a college career and have been found wanting, as well as from those who have had no such aspirations. It is generally understood that the best students are preparing for college. There is a distinct line of demarcation between the university aspirant and the "commercial." The same line of demarcation may be found in any college or university, large or small. It is considered one thing to prepare for arts and science and another to prepare for business. It is also one thing to prepare for the learned professions and quite another to prepare for accountancy. This is in explanation of the attitude of the student mind, although we can not overlook the fact that it is undergoing a change. It remains true, nevertheless, that our most capable and brilliant students do not choose the schools of commerce for their educational activities.

We are now in a period of transition, and it is evident that the rapid development of commercial courses in our schools and universities will bring about their elevation to a more desirable place in the curricula. It is also quite evident that, in the near future, our schools and universities will cease to look for their strength as educational centers in mere numbers and will base their claim to prestige on the quality of the gray matter with which they will have to work. It is well known in educational circles that only about ten per cent. of the student body rank in the nineties. It would be possible to eliminate about fifty per cent. of the students in our high schools and universities without experiencing any great loss or causing any great damage to the future of the race. It is indeed galling to the serious and educated student to note the number of his classmates who have succeeded in sliding through and who 'sport a college degree. But the signs of the times are plain enough for all to read who may, and our idealists may yet have cause for delight.

The time has not yet come, but it is to be hoped that it will not be too long in coming, when most of the candidates for the C.P.A.

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certificate will be drawn from our colleges and universities, and it is to be hoped that many of them will be men of liberal education who after they have been through the drudgery of the accountant's profession will add prestige to it by virtue of their wider knowledge. It must be admitted that, under the new educational régime which is inevitable, they will have accomplished something worth while and will have shown their capacity for serious study. In this way, the future of the profession will be assured, and it will attain a much higher standard and claim as general a recognition as it has enjoyed for so many years in other and older countries.

## The Scope of Special Investigations

BY GEORGE V. KRACHT

Special investigations constitute a distinct and rather exciting line of accounting activity. In each case the examination is conducted for the purpose of solving some specific problem or in order to obtain the answers to a set of given questions. Consequently the scope of the investigation is in some respects broader, in other respects narrower, than that of the audit.

Several types of special investigations can be distinguished, some of which represent comparatively recent additions to the public accountant's functions. The more important are:

- (a) Examination for credit purposes. The security for a loan, as distinct from an investment, is involved in the problem here presented.
- (b) Examination in order to ascertain probable future profits. Into this category would fall investigations made in order to determine the fair value of the net assets or of the capital stock of a going concern; or in order to ascertain the probable profitableness of an investment in a concern when such investment will constitute an addition to the net capital of the enterprise.
- (c) Examinations incident to corporate consolidations and mergers. In some cases values would be determined by the examiner in accordance with the principles stipulated in a preliminary agreement, while in others no restrictions would be placed on the scope of the investigation. The examiner would merely be given a general order to formulate a written opinion with regard to the values at which the consolidating enterprises should participate in the transaction, and perhaps to state his conclusions relative to the effect of the suggested project on earning power.
- (d) Examinations undertaken for the purpose of obtaining the accountant's suggestions on policies to increase profits. Usually in these cases the concern is losing money and wishes to find the causes of its difficulties.

While each of the classes of examination established is clearly separable from the others, it will be noted that certain problems

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are common to all. For example, in dealing with the ability of a concern (particularly a comparatively young concern) to repay a long-term loan with interest under certain stipulated conditions, such factors as personnel, nature of product, patent protection and others must be investigated, the same as in (b), (c) or (d). The difference lies mainly in the emphasis which should be laid on each factor. This would shift materially, not only between the classes of investigations established but to some extent between the individual cases embraced by each class. A client considering a large investment in a relatively new enterprise would usually be much more interested in personnel than would one who wished to know whether the same enterprise would be able to repay his loan with interest. However, in both cases the factor of personnel would be important to the inquiry.

Similarly, while classes (b) and (c) are so closely allied that the same problems will be met in both, each also has its special features. In one case an important issue to be faced might be the effect upon earnings of the additional capital invested, while in the other the consequences of consolidation or merger might claim the greater share of the examiner's attention and report. These are matters upon which little of general interest or benefit can be said.

In the present article the inquiry is limited to a discussion of the major problems involved in an investigation of the class (b) type. The critic should remember the reservation made to the effect that the stress laid on the factors common to the individual cases within each class will vary more or less widely.

As an incident to the inquiry it will be necessary to adopt a personal opinion as to how far the examining accountant should go in treating of such factors as personnel, patent protection, etc. Perhaps thereby a discussion may be provoked which will serve to define the opinion of the profession relative to these highly controversial points.

Any report on an investigation of the type under discussion should comment on the following factors, usually in the order presented:

- (a) Organization and history
- (b) Nature of products
- (c) Patent protection
- (d) Competition and market



- (e) Personnel
- (f) Financial statements and discussion thereof
- (g) Special features

This sequence evidences neither the emphasis to be laid on the factors nor the order in which they would actually be investigated. The actual procedure of the examination must remain largely a question of taste, convenience and special circumstances.

#### ORGANIZATION AND HISTORY

Only in rare cases are all the persons for whom the report is destined sufficiently acquainted with the concern examined to render unnecessary a brief statement of facts under the caption "organization and history." A corporation—an industrial enterprise—is the subject of the report, and the first thing the report must do is to identify that subject or introduce it to the reader. This means that it must outline the company's salient characteristics as disclosed by its history. Even when dealing with an unorganized project, a general statement of this nature is desirable.

Terseness is an essential quality of this opening chapter but no fact of importance should be omitted. The report on the investigation should be so complete that a reader absolutely ignorant of the facts at issue could, after reading the report, come to a decision as to whether or not he wished to invest in the enterprise. Nothing is more irritating than to peruse a report which assumes that the reader is acquainted with facts which are all-essential to any clear understanding of what the discussion is about.

Under organization and history the following information should be given with as much brevity as is consistent with a continuous and readable treatment of the subject:

- (a) Name of company, date of organization and state in which organized.
- (b) Capital stock authorized and outstanding; par or stated value of various classes of shares, etc.
- (c) Location of principal offices.
- (d) Product or products sold; whether or not they are specialties, and, if so, whether or not they are patented.

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- (e) Nature of organization; i.e., whether manufacturing or distributing. If purely a sales organization, by whom are products manufactured?
- (f) Reasons why further financing is necessary and why the suggested mode of financing has been selected. This would be relevant only when capital funds are sought by the concern.
- (g) Expansion and present status; location of sales offices, if any; capacity of plant, etc.

These suggestions are not intended to be exclusive. In the case of an unorganized concern most of them would apply with obvious qualifications, while in other cases amplification would be desirable. How far the report should go is largely a matter of judgment. This opening chapter should serve as a sort of bird's-eye view of the situation, and the examiner must be guided by the circumstances of that situation and by his own discrimination.

#### NATURE OF PRODUCTS

The extent of the discussion under the heading, "nature of products", will depend largely upon whether the products are staple commodities or specialties. In either case the treatment should be so extensive that no pertinent interrogation of importance will go unanswered. Concrete suggestions of a general nature are dangerous to make because of the varied subject matter involved. For purposes of illustration let us select a concern fabricating or selling a building specialty to contractors and wholesalers. Points to be treated would be:

- (a) What is the function of the specialty?
- (b) What is its construction?
- (c) How is it tested to guard against claims for damages because of inferior construction?
- (d) What product is it designed to displace and what is its range of adaptability? The answer to this latter question must be discussed in another part of the report, so that only a general statement is necessary here.
- (e) What are its points of superiority over competing products, and what are its inferior features or its limits, if any?

- (f) How does it compare in cost with such competing products?
- (g) Can the organization or the plant facilities be easily adapted to the production and marketing of allied specialties?

It will be recognized that by this time even a reader previously uninformed would have pretty well fixed in his mind the nature of the project in which he is interested. For the most part he has been absorbing facts and has been led logically to the more stubborn field of opinion. He is now in a position to bring his own judgment to bear upon the situation and to examine critically the debatable matter which follows. This presentation of matter in its proper sequence will make considerable difference in his final estimation of the report.

#### PATENT PROTECTION

If the concern investigated produces or sells a specialty, patent protection is quite important. While the examiner must usually rely upon the opinion of competent attorneys as to the adequacy of the protection afforded by patents, he must decide the stress which should be laid on this factor in the report.

Only in exceptional cases can it be definitely stated, in advance of litigation, that patents granted or claims approved will be effective against future substitute competition. Very few patents are really basic in nature, and the fact that a claim has been granted and can be upheld against infringement often proves very little. Consequently, the examination should go behind the opinion of the attorneys to the extent of determining the importance which should be assigned to this factor in the construction of the final equation.

The following inquiries are suggested as ones likely to arise in the mind of the prospective investor when reading this section of the report:

- (a) What attorneys have passed upon the patents?
- (b) What is the gist of their formal opinions?
- (c) Have the patents ever been involved in litigation and, if so, what is the present status thereof?
- (d) Have any royalties been paid on the patents either in the United States or in foreign countries?
- (e) Can the product be made with a relatively small investment in special machinery? It is not desirable to go into

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details here, as this point must be fully discussed under another heading.

- (f) Is the management aware of the necessity of acting with promptitude against infringements of the patents?
- (g) Has any goodwill been built up or has the product become identified in the minds of possible purchasers by a trade name?
- (h) What generally would be the effect on the enterprise of the effectual invalidation of the patents?

In answering this last question, the examiner must weigh the various factors involved and determine just how much damage would result from the impairment or invalidation of the patents. These factors are, of course, intangible, or at least can not be reduced to dollars-and-cents values. They are nevertheless interdependent and permit the formulation of a defensible opinion. For instance, if the investment in special machinery is comparatively small, less weight need be assigned to the adequacy of patent protection than if it is considerable. If the product could easily be turned out as a side line by existing concerns without seriously interfering with other production processes, that would tend to make the question of protection more critical. On the other hand, goodwill built up might counteract to a large extent the effect of direct competition made possible by the failure of the patents.

In passing judgment upon these matters the examiner is strictly within the sphere of public accounting activity. While there seems to be a tendency on the part of some members of the profession to reduce it to a purely fact-finding body, and to withhold opinion where the evidence can not be reduced to definite dollar values, that tendency, if allowed to work its way, must necessarily be fatal in the long run. Where the factors to be measured are those with which the accountant's experience qualifies him to deal fairly and impartially, it is an evasion of responsibility to reject the task merely because such factors are not subject to exact quantitative analysis. This will be discussed fully elsewhere in this article.

### COMPETITION AND MARKET

Competition may be of two kinds—direct and substitute. The examiner must ascertain the principal sources of both types, so far as they affect the concern in which he is interested, and

discuss them with regard to competing products and competing concerns. It is obvious that in many cases a large part of this field will have been traversed when treating of patent protection.

Closely related to the factor of competition is that of range of marketability. Here we have left so far behind the region of assured fact that the competence of the examining accountant to deliver an opinion must be considered. Without plunging into the highly debatable question of the functions of public accounting (and by way of passing it may be remarked that the question is one upon which some mental effort might be expended with profit), this much can certainly be laid down with safety. The fact that the premises from which the conclusion must be drawn are necessarily incomplete is not pertinent to the subject. Neither is the correlative fact that two competent accountants might arrive at different conclusions after examination of the evidence. If we restrict the activities of our profession to the extent that no factual opinion is to be rendered which will not be accepted by all competent accountants, we are dangerously near to allying ourselves with the highly skilled trades. And this is by no means sighing for new worlds to conquer. Every profession has its twilight zone, within which the practitioner can do no more than point dimly to probabilities as he discerns them. Every lawsuit is both won and lost. In the medical fraternity the wrangle over various diseases has continued unabated through the past decades. We must not forget the violent disagreements in various "insanity" trials—which if they have produced some scorn and imputations of bad motives, have also served to enlighten the public on obscure questions. So that if experts differ on a subject—as they often do—it is no reason why they should maintain an innocuous silence.

In the present case—that of passing an opinion on the range of marketability of a product—the critical point is whether or not the examining accountant is better qualified than others to formulate such an opinion. We can even go further and say that the critical point is whether or not the examiner's training is such that his opinion is a detail to be considered in a complex situation. If so, he can accept with a free conscience the responsibility of making his contribution to that situation.

Now the accountant does have much in his favor. There are his impartiality, his general knowledge of industries and products, and his particular knowledge of the accounts of the concern under

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examination during the period in which it has operated. His experience should have taught him, if he has been alert, the factors to be weighed in forming an opinion on the point under consideration, and some of these factors are such that he alone can properly value them. On this account the examiner should not hesitate to accept the challenge.

Under marketability there must be considered:

- (a) Average life of articles produced.
- (b) The cost of production in comparison with that of substitutes.
- (c) Cost of transportation to distant markets, and other factors bearing thereon.
- (d) Data on growth of sales in the past and on the history of products which the articles are designed to replace.
- (e) Has the article a general or restricted use; a local or a national one?
- (f) Is it to be sold to producers or to the ultimate consumers?
- (g) Is it to be marketed direct or through distributors?
- (h) What artificial obstacles, if any, are competitors likely to interpose?
- (i) Have the articles a quick or a slow appeal?
- (j) If the commodities are standard, what particular places can be served more cheaply by the new concern than by competitors?
- (k) How much will the concern, given the additional capital, be able to spend on advertising?

This list is necessarily suggestive rather than exclusive. The opinion to be rendered is whether or not the product can be made cheaply enough to cut into direct and substitute competition and, if so, to what extent? Obviously only the investigator in touch with all the features of a concrete situation can exhaust the inquiries relevant thereto.

### PERSONNEL

After marketability comes personnel. The relative weight to be assigned to this factor depends upon various circumstances. Personnel is of importance in interpreting past profits as well as in framing estimates of future ones. If the management has been poor, so much the more reason for expecting better results in

the future if a change can be effected; if on the other hand profits depend largely upon the retention of the present personnel, every fact bearing upon the probability of its retention is important.

The report should state briefly all pertinent facts about the officers and principal executives, their age, general and technical education, business history, etc.

Naturally much of this information can not be derived from independent sources without extreme difficulty, and usually it is advisable to accept the statements of the persons themselves. Fortunately the character of the evidence is such that ex parte affidavits, or even unsworn statements, will suffice. However, in accordance with the theory that the report should be complete in itself, the data should be included in every case. To the prospective investor in a concern there is no inquiry more vital than this one, even if the acquisition of control is contemplated.

Under personnel the examiner should present his opinions regarding the personal qualities of the company's chief executives. Unfortunately, despite the blatant claims of many pseudo-psychologists, no science of character reading exists. Otherwise the public accountant specializing in investigations, system installations and surveys might well add a knowledge of its principles to his equipment. However, trustworthy psychologists inform us that extended experiments have failed to disclose any correlations between physical and mental characteristics.

The examiner must consequently fall back upon the personal interview and the evidence disclosed by the records as bases for his opinions. These sources are not so limited as might be assumed at first sight. The examiner presumably has a knowledge of the basic principles of industrial organization. While not a purchasing agent, for example, he knows what records should be kept by a competent purchasing agent and what qualities a purchasing agent should possess. By means of a series of interviews the examiner can gauge pretty accurately the capabilities of the various officers and express opinions which stand a reasonable chance of being correct.

It should not be understood by this (and the impression must on no account be given) that the examiner is an expert along the varied lines of administration, purchasing, selling, producing, etc. All he can pretend to know are the general principles controlling industrial organization and the broad lines of activity pur-

sued by capable general managers, factory superintendents and other executives. He is essentially a critic—not a creator. And that he may make mistakes is merely an incident to the nature of his functions.

Obviously where a concern has operated for any considerable period of time, the testimony afforded by the records themselves will be of value.

The report should disclose under personnel the stockholdings of the officers and principal executives together with all facts bearing upon the probable tenure of office of each executive. The failure or success of an industrial enterprise is so intimately related to problems of personnel that all the examiner's knowledge, experience and talent should be brought to bear upon this feature of the situation.

In presenting his conclusions, the examiner should state his opinions clearly and definitely, disclosing the bases upon which they rest. He should carefully separate mere impressions without tangible reasons therefor from considered inferences.

#### FINANCIAL STATEMENTS

Statements of operating results and balance-sheets, together with the various analyses of their contents, are usually considered of first importance in reports for credit purposes.

Even if one were disposed to concede this, such statements would be more informative if prefaced by remarks similar to those called for under the preceding captions. While the stress laid on each of the factors discussed would necessarily vary—as it must even in individual cases comprised in the special class of investigations under consideration—a report for credit purposes can scarcely be judged complete without some treatment of them.

At any rate, in reports on investigations for practically all purposes, no statements should be presented or analyzed until the matters previously considered in this article have been covered. What statements should be compiled represents a subject with which all public accountants should be familiar. The ideal mode of presentation probably consists of very condensed major or controlling statements, which proceed to details through carefully graduated stages. The statements constructed by many accountants are too large and contain too many figures. Allowance must be made for the comparative unfamiliarity of most



readers with the data presented as well as for the limitations of the human mind. There are few laymen who can discern the significant relations subsisting between figures as rapidly as can the trained accountant. Figures are in many respects the language of the accountant and he must take every possible precaution to make himself understood. It is debatable whether in our efforts to standardize we are not neglecting the very essence of professional service—originality and personal touch.

In analyzing statements, graphic charts (particularly the ratio or semi-logarithmic chart) should be profusely used. These serve to illuminate the rather colorless arrays of figures and to brighten up the report.

#### SPECIAL FACTORS

Having discussed the statements rendered, the examiner is in a position to deal with any special features which characterize the problem with which he is concerned. These vary so widely that an attempt to do more than illustrate what is meant would be futile. Let us choose one instance among many possible ones.

A situation which frequently leads to a special investigation is one where a comparatively young concern wishes to expand, or perhaps one where a distributing organization which had been selling a specialty wishes to start manufacturing its product.

Let us suppose that the men actively interested in the enterprise decide that the best way to effect their plans is to induce a group of local capitalists to buy stock in the enterprise. They have succeeded in arousing the interest of the capitalists to the extent that the accountant's investigation has been ordered.

So far the accountant's report has informed each capitalist of every fact relevant to his inquiry as to whether or not he should invest and, if so, on what terms. He knows the history of the concern, its products, its market possibilities, the qualities of the men behind it as they appear to an outside investigator, past operating results, etc. In the discussion of market, he has reached a general conclusion relative to the advisability of expansion if that be the proposed disposition of the additional funds. It is now time to present the grounds necessary to make that conclusion specific. These would be:

- (a) The necessity of expansion or of acquiring the facilities requisite to manufacture a product previously purchased from others.

- (b) The capital required to effect the desired extension of facilities. This is an exceedingly complex calculation as the examiner must take into consideration not only the cost of the fixed assets but the necessary addition to working capital in the form of larger amounts invested in inventories, accounts receivable, cash, etc. Naturally the cost of the facilities acquired must be arrived at through the medium of detailed estimates predicated upon the desired increase in production. Special machinery should be segregated in the estimate for obvious reasons. The effect of varying quantities of production (and sales) upon working capital should be disclosed and allowance made for the accretions to working capital through profits before full production is reached.
- (c) An estimate of earnings. This should be developed by using estimated sales and costs in detail. In short, it should be in the nature of a budget constructed on the basis of the probable effect over a period of years of the new money coming into the business. The examiner himself is the only one who can set the limits to this field of inquiry.
- (d) Probable rate of return on investment.

The chief advantage of reducing opinions on the foregoing points to actual figures is that the prospective investor has a visible means of checking the thoroughness with which the investigation has been conducted and the value of the conclusions reached in the report. While it is not generally advisable to express opinions and their premises in detailed money values, particularly where a false impression of accuracy is likely to be conveyed thereby, this seems to be a case where that mode of presentation is fully justified.

In constructing an estimate based partly upon past operating results the effect of radical changes in price levels upon such results must be carefully considered. This is a factor frequently neglected—not without serious consequences. Similar considerations will doubtless occur to all accountants.

It will be apparent that the content of this section of the report depends so much upon the special problem to be attacked that

(at least in the present state of knowledge) little that is helpful in the line of suggestions can be laid down.

The literature on investigations is by no means prolific, and probably at the best can never be more than suggestive. The purpose here has been to formulate tentatively the major lines of inquiry to be pursued, to propose an outline of a report and to suggest certain particular methods of approach to the problem.

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A. P. RICHARDSON, *Editor*

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## EDITORIAL

### Accountant Owns His Working Papers

The decision rendered by the supreme judicial court of Massachusetts in the appeal from the finding of the superior court of Suffolk county, Massachusetts, in the case Ipswich Mills against William Dillon and another, is perhaps the most important adjudication by a court of last resort in the legal history of accountancy. The decision was unanimous and supported in every particular the contention of the accounting profession that the accountant is and always will be, in the absence of express contract to the contrary, the owner of the working papers which he compiles preparatory to the final report. To the accountant this has always seemed so obvious that to call in question the right to his working papers and similar preliminary documents has savored of the absurd. There has never been any principle of law or equity which has appeared to cast doubt upon the validity of a professional man's absolute title to what is solely his property and not by any stretch of imagination the property of any one else. It is true that there may be cases of such extraordinary nature that the parties may agree to hold in a common place of secrecy and safety all documents which may have a bearing upon the matters at issue, and such a repository may be the office of the accountant or of the client. But fortunately these instances are very rare and when they occur are almost invariably covered by a specific contract or agreement. In the absence of arrangement for such exceptional privacy, custom of the profession vests ownership of everything other than the original copy of the final report in the accountant. This custom is based upon equity and common sense as well as upon analogy of the precedents set in other professions. During the last few years, however, there has arisen in a few instances an inclination to deny the right of the accountant to his working papers. In the new law for the regulation of the ac-

counting profession in Florida it is provided that all working papers shall be and remain the property of the accountant, and this indicates nothing more than a desire to remove from the category of uncertainty a question of vast significance to the profession. It seems strange that this vital question should have been answered solely by precedent and custom all these years and that there was, prior to the case now under consideration, no decision by a competent court confirming to the accountant the rights which by common consent have always been his. Probably the absence of appeal to the courts has been due to the self-evident justice of the accountant's claim. Whatever the reason may be, the fact remains that the decision now rendered by the supreme court of Massachusetts is the first on record. The precedent thus set should be controlling, for the court from which the finding emanates is one of high repute and long established ability.

**The Institute Enters  
the Case**

When the case was first heard and the accountant's rights appeared to be jeopardized the matter was reported to the American Institute of Accountants. It seemed to the Institute's executive authorities that this was a case in which the whole profession was intimately concerned and, accordingly, counsel for the Institute was requested to take such steps as were necessary to secure a reversal by the highest court of the state. Thereafter the case was conducted by the Institute's counsel and counsel for the Massachusetts Society of Certified Public Accountants and the costs involved were assumed by the Institute. Had the judgment of the lower court been permitted to stand unchallenged the whole profession might have been annoyed by claims of clients based upon the *Ipswich Mills-Dillon* case and the weight of a precedent would have been against equity and law. It was better therefore to appeal at once and thus to set at rest the question which had arisen and had been answered in the lower court in a way which would have been subversive of justice. Now the supreme judicial court has rendered the decision which was expected and right is done. The chief argument of the plaintiff's counsel throughout the case was that the accountants were employees of the company and that the accountant's assumption of status as a professional practitioner was not tenable. The judgment now rendered disposes, we trust for all time, of the idea that public accountancy is not a profession. It should be added

*Editorial*

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that Judge Weed of the lower court, realizing the importance of the case, had reported it to the supreme judicial court for a review of his decision.

**Brief of  
Amicus Curiae**

The case is of such far-reaching importance that we make no apology for quoting extensively from brief and from judgment. The brief presented on behalf of the defendants was prepared by J. Harry Covington of Washington, D. C., chief of counsel for the American Institute of Accountants, and by Robert G. Dodge, counsel for the Massachusetts Society of Certified Public Accountants. It categorically dissents from all the findings of the lower court excepting as to the ownership of certain papers which originated in the plaintiff's office—the defendants had conceded this point from the beginning and had not made any claim to ownership. The high court's decision accepts all these contentions and sustains the arguments. Before presenting the judgment of the final court it is of interest to consider the supporting brief of amicus curiae, representing the American Institute of Accountants.

IN THE SUPREME JUDICIAL COURT FOR THE COMMONWEALTH  
Suffolk county March sitting, 1927

(No. 2237)

IPSWICH MILLS

*v.*

WILLIAM DILLON AND SCHUYLER DILLON

BRIEF OF AMICUS CURIAE, REPRESENTING THE AMERICAN INSTITUTE OF ACCOUNTANTS

This brief is filed on behalf of the American Institute of Accountants in support of the defendants' position in this case.

The American Institute of Accountants contains within its membership persons in all parts of the United States who are engaged in the practice of public accountancy. In each of the forty-eight states and the District of Columbia there are statutes regulating such practice, and providing for examinations designed to demonstrate technical skill in accountancy and education in related subjects on the part of a person as a prerequisite to the issuance to him of a certificate as a certified public accountant. Such persons thereafter hold themselves out to the public as ready to perform the highly skilled services required of a public accountant today, and they are engaged by their clients as professional persons to do specific tasks in the field of accountancy. The defendants in this case are certified public accountants duly

admitted to practice in the state of Massachusetts (Record, pp. 20 and 122).

The trial court correctly found, among other things, as follows:

"I find that the term 'work sheets' means papers on which original compilations, computations and analyses are made by accountants which later are gathered together in a summary form and the figures rendered in the schedule, exhibit, report or return upon which the accountant is working" (Rec. p. 15).

But the court, while holding that the preparation of the "work sheets" or working papers was work of a character requiring accounting skill and experience and good judgment in reaching sound and dependable conclusions where original entries were obscure or vouchers missing, erroneously held in respect of the possession of the "work sheets" as follows:

"By fair implication the information gained by the defendants and compiled on the work sheets and even the paper itself is the property of the plaintiff. If the defendants have any interest in the papers and the information there gathered, it is solely for the purpose of defending the integrity of their work, and goes no farther than suitable protection against the destruction or alteration of such papers and not to a superior right to the possession thereof."

This is apparently the first case in the United States which directly involves the question whether the accountant owns his working papers, and the *amicus curiæ*, representing the accounting profession of the country and believing the position of the defendants regarding the ownership of such papers to be correct, supports their contention.

In the work of the accountant, whether in regard to making the ordinary annual audits and reports, or in regard to the preparation of evidence for an income-tax case, there is involved an examination of the books, records, vouchers, etc., of the accountant's client. Of course, these books, records, vouchers, etc., belong to the client. The accountant simply examines them, either in the office of the client or, in some cases, he may take them away to his own office. As he makes the examination, it is the practice to make notes of the facts which the accountant believes will be material as a basis for his report or opinion. In practice these notes are usually made on long sheets of paper which the accountant designates as his working papers. Thereafter, from his working papers the accountant compiles the final report, which he certifies as an accountant and which he submits to his client.

If at the conclusion of his professional task for which he has been employed the accountant, after delivering his report, should destroy all his notes, that is to say, his working papers, certainly no action in tort would lie for such action. And yet, if the title to such working papers is in the client, the right to recover in such an action would be the logical conclusion.

Without burdening the court with additional argument, it is urged that the right of the public accountant to retain the possession of his working papers subject to any legitimate interest of

*Editorial*

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his client is obviously a vital one to him and is based upon the soundest considerations.

And the amicus curiæ, having read the brief of the defendants, concurs in the arguments presented therein.

Respectfully submitted,  
SPENCER GORDON, Washington, D. C.  
Of Counsel for  
American Institute of Accountants.

**Judgment of  
Supreme Court**

This brief summarizes with commendable clarity the essential points at issue. It is not with the details of an individual case that the Institute is primarily concerned. It is very greatly concerned, however, with the protection of the profession as a whole. And now after ample time for consideration the court of last resort renders the decision which is destined to be a leading case for years to come.

IPSWICH MILLS *v.* WILLIAM DILLON AND ANOTHER

Suffolk. Argued March 8, 1927      Opinion filed July 5, 1927

Present: RUGG, C. J., BRALEY, PIERCE, CARROLL, & WAIT, JJ.

*Accountant*, Ownership of letters, work sheets, and memoranda.  
*Agency*, Independent contractor.

Reservation and report by *Weed*, J., of a suit in equity heard by him in the superior court.

CARROLL, J. The question involved in this suit in equity is the ownership of certain papers. The plaintiff is a manufacturer of hosiery. The defendants are accountants, father and son, who have been partners since January 1, 1921. In 1912 or 1913 the father, and later the firm, were employed by the plaintiff as accountants to make an annual audit, to prepare tax returns, and to perform services on matters of bookkeeping, cost accounting and statements for banks. This employment continued until December, 1925. In 1922 or 1923 the defendants were employed to conduct a federal tax case before the bureau of internal revenue as attorneys in fact for the plaintiff. While a federal revenue agent was making an examination of the plaintiff's returns for the years 1922, 1923, 1924, he was sent by the plaintiff to the defendants to examine certain papers in their possession relating to the plaintiff's affairs, more particularly the defendants' "work sheets" relating to the revaluation of the plant assets and to certain adjusted inventories developed in their work on the tax case. The defendants refused the revenue agent access to these papers. On



January 6, 1926, the plaintiff demanded of the defendants "all papers in your possession belonging to Ipswich Mills." No papers were delivered and this suit was instituted.

All the papers involved which were in the defendants' possession were produced by them at the trial. They were examined by the parties, grouped, initialed and impounded, awaiting the final decision of the case. Group A consisted of papers that originated in the plaintiff's office or in the office of its selling agents, or of someone associated with them, including papers relating to the 1917 federal tax return of the plaintiff. The defendants conceded that the plaintiff is the owner of these papers in group A, and entitled to possession of them. Group B included copy of the amended federal tax return of the plaintiff for the year 1918, and certain papers (not work sheets) relating thereto. In group C there were copies of the plaintiff's tentative and amended tax return for 1919 with work sheets and correspondence in connection therewith. In group D were papers and work sheets of the revaluation of the plaintiff's plant assets. The papers in group E were the defendants' work sheets of their July, 1922, report. Group F included papers, reports, returns, copies, work sheets, data, correspondence and memoranda respecting the tax case, together with some letters originating in the plaintiff's office.

It was found by the trial judge that work sheets meant papers on which original compilations, computations and analyses are made by accountants, which later are gathered together in a summary form and the figures rendered in a schedule, exhibit, report or return upon which the accountant is working. The judge ruled that the plaintiff was the owner of the papers in groups B, C, D and E, and entitled to the immediate possession of them, the defendants being entitled to take and preserve such photostatic copies as they desired. With reference to the papers initialed F, the judge ruled that the parties were jointly interested in these particular papers, with the right in the plaintiff to take them temporarily from the defendants. An order for a decree was made. The case was then reported to this court.

Concerning the papers marked B, which consist of "copy of amended federal tax return of the plaintiff for 1918 and certain papers (not work sheets) relating thereto," the judge found "the defendants were under employ as accountants—auditing, checking up and verifying, and making a research for the original costs of the plaintiff's plant assets then in use and applying depreciation figures decided upon by the directors with respect to the different classes of property. It was work of a character requiring accounting skill and experience, and good judgment in reaching sound and dependable conclusions where original entries were obscure or vouchers missing. It was fully paid for by the plaintiff." We assume that the original tax return was delivered to the plaintiff and the copy of this return retained by the defendants. The

defendants were not the agents or servants of the plaintiff; they were independent contractors. In the making of the documents and papers and in collecting the information involved in them, the defendants were independent accountants engaged in their own occupation. See *Pearl v. West End Street Railway*, 176 Mass. 177, 179; *Leverone v. Arancio*, 179 Mass. 439, 443. They had the right to make and retain copies of the tax return. It might be necessary to have possession of the copies if the accuracy of their work was questioned. There was nothing in the contract of employment which required the defendants to surrender this copy and in the absence of such an agreement they could not be compelled to surrender it. The other papers relating to the federal tax return of 1918, mentioned in group B, we understand are office copies of letters sent by the defendants. The defendants could retain copies of these letters as well as copies of the schedules which are indicated by the evidence as being a part of the "papers . . . relating thereto." This copy of the return and the papers relating thereto may have contained information of importance to the plaintiff. The right of the plaintiff to restrain its publication is not before us. Even if it be assumed that the defendants could be enjoined from the publication of the contents of these papers, the title to them was in the defendants.

Group C consisted of (1) carbon copies of letters from the defendants to the plaintiff; (2) original letters from the plaintiff to the defendants; (3) original letters to the defendants from the plaintiff's attorneys; and (4) carbon copies of letters from the defendants to the collector of internal revenue.

The carbon copies of the defendants' letters to the plaintiff were the property of the defendants. The plaintiff did not own these copies and was not entitled to their possession. The contract of employment did not require the defendants to furnish these copies to the plaintiff.

The original letters from the plaintiff to the defendants belonged to the defendants. They were the recipients, and therefore owned them. It was decided in *Baker v. Libbie*, 210 Mass. 599, 606, after an exhaustive review of the authorities, that as a general rule the publication of letters may be restrained by the author, but in the absence of some special arrangement the recipient of the letter is the owner. "The author parts with the physical and material elements which are conveyed by and in the envelope. These are given to the receiver. The paper upon which the letter is written belongs to the receiver. *Oliver v. Oliver*, 11 C. B. (N. S.) 139. *Grigsby v. Breckinridge*, 2 Bush, 480, 486. *Pope v. Curl*, 2 Ark. 341. *Werckmeister v. American Lithographic Co.*, 142 Fed. Rep. 827, 830. A duty of preservation would impose an unreasonable burden in most instances. It is obvious that no such obligation rests upon the receiver, and he may destroy or keep at pleasure." The same principle is applicable to the letters sent from the plaintiff's attorneys to the defendants. As the de-

defendants were the receivers of these letters, they were the property of the defendants.

The carbon copies of the defendants' letters to the collector of internal revenue did not belong to the plaintiff. Whatever right it may have to examine these copies, or take copies of them, which point we are not called upon to decide, the defendants' copies did not belong to the plaintiff; they were owned by the defendants. The fact that the copies of these letters concern the plaintiff is not a sufficient reason for depriving the defendants of their property. In writing the letters the defendants were not the plaintiff's servants.

In group C there are copies of federal tax returns. These, as we understand from the record, were the defendants' office copies. The record shows that copies of all returns and schedules prepared by the defendants for the plaintiff were sent to the plaintiff. Even if the plaintiff has a right to require further copies, a question not involved in this suit, it has no right to demand of the defendants the surrender of these office copies. They were the property of the defendants.

The work sheets, as defined by the trial judge, were the defendants' property. They were made by them while engaged in their own business. The paper on which the computations were made belonged to them. They were not employed to make these sheets. The sheets were merely the means by which the work for which the defendants were employed might be accomplished. The title to the work sheets remained in the defendants after the computations were made. In the absence of an agreement that these sheets were to belong to the plaintiff, or were to be held for it, they were owned by the defendants. It may be that these papers contained information confidential in its nature and of importance to the plaintiff; but the defendants did not receive this information as the plaintiff's servants. It has been held that plans prepared by an architect employed for that purpose belong to the one for whom they are made. *Walsh v. St. Louis Exposition & Music Hall Association*, 101 Mo. 534, 535. *Gibbon v. Pease* [1905], 1 K. B. 810. See *Kutts v. Pelby*, 20 Pick. 65, 66. But it has never been decided so far as we know that the preliminary plans and sketches of an architect belong to the person by whom the architect is employed, see in this connection *Rutan v. Coolidge*, 241 Mass. 584; nor has it been held so far as we are aware that the preliminary sketches and drawings of an artist employed to paint a portrait belong to the sitter; or that memoranda made by a physician of his examination of a patient, or the notes and records of a lawyer, his preliminary drafts of legal documents or his minutes of testimony, belong respectively to the patient or client. See *Anonymous Case*, 31 Maine, 590; *In re Wheatcroft*, 6 Ch. D. 97. As to property rights in a negative where a photograph is taken for pay in the usual course, see *Boucas v. Cooke* [1903], 2 K. B. 227, 238; *Pollard v. Photographic Co.*, 40 Ch.

D. 345. 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. They were made by the defendants solely for their own assistance in preparing the tax returns.

With reference to group F, the letters addressed to the defendants, copies of letters written by the defendants, copies of returns furnished to the plaintiff, and work sheets relating to the tax case, are the sole property of the defendants, and this is true of the papers and reports collected by the defendants in the preparation of the tax case. The plaintiff is not jointly interested with the defendants in these documents. We do not understand that any of these reports, papers and returns were property of the plaintiff which had been placed in the defendants' custody by the plaintiff or merely delivered to the defendants. If there are any papers belonging to the plaintiff which were lent to the defendants, the plaintiff is entitled to them; but as we construe the record, the papers referred to in group F were gathered and collected by the defendants in the course of their business, and were not papers of the plaintiff placed by it in the defendants' possession.

On the record of the evidence disclosed in this case, the defendants were under no legal obligation to surrender their working sheets or other papers to the plaintiff. The testimony of Leonard and Dillon does not prove that the defendants gave the plaintiff any right or title in them. It is apparent that at one time papers in the possession of the defendants, including their working papers, were turned over to the plaintiff, for which receipts were given by the plaintiff to the defendants. These papers were again returned to the defendants. The plaintiff contends that by this transaction the plaintiff's rights of property and possession of all these papers were settled. Dillon testified that these papers were merely lent to the plaintiff. An investigation of the letters and receipts, and an examination of the record, do not satisfy us that the defendants in placing these documents in the possession of the plaintiff intended to part with their title and property in them.

It follows that the papers in group A belong to the plaintiff. The other papers and documents belong to the defendants. A decree is to be entered for the plaintiff, directing that the plaintiff is the owner and entitled to immediate possession of the documents described in group A.

*Ordered accordingly.*

J. Harry Covington, of Washington, D. C., representing the American Institute of Accountants, and Robert G. Dodge, of Boston, Massachusetts, representing the Massachusetts Society of Certified Public Accountants, appeared formally and filed a brief on behalf of Mr. Dillon. Spencer Gordon, of Washington, D. C., filed a brief as friend of the court on behalf of the American Institute of Accountants.

There is nothing to add to the conclusiveness of this decision. The accountants in the case, the Institute and especially Institute counsel are to be congratulated upon a complete vindication of inherent right.

**Institute's Annual Meeting**

Every member of the American Institute of Accountants who can attend the annual meeting to be held at Del Monte, California, next month will be fortunate. The responses which are coming in indicate that there is a widespread interest in the arrangements which are being made for the comfort and entertainment of those who will attend. The meeting of the Dominion Association of Chartered Accountants at Winnipeg is one of the most attractive features of the trip which has been planned for members from east of the Rocky mountains. The hospitality of the Canadian accountants is well known to many persons who have been present at the Dominion meetings of past years. All Americans regard the people of Canada as friends and it is ever a pleasure to meet and reaffirm the sentiments of international amity for which such a convention as that of Winnipeg gives opportunity. After the American expeditionary forces leave Canada they are to spend three days in Yellowstone Park, which in September is at its beautiful best. Thence the itinerary includes Spokane, where there is to be time enough for sightseeing and a dinner dance. At Seattle there will be an entire day and at Portland time enough to see some of the most important things which that city has to offer. At San Francisco there will be a party at the Bohemian Club and a trip to Mount Tamalpais. The train will arrive at Del Monte in the late evening of Sunday, September 19th. After the meetings are over the train will then proceed to Los Angeles, where there will be three days devoted to sightseeing and entertainment. The party leaves for the east on Monday, September 26th, and after stopping at Riverside and spending a day and evening at the Grand Canyon, is due to reach Chicago on September 30th. Papers already announced for the annual meeting include an address by Henry Rand Hatfield of the University of California and one by Robert H. Montgomery, whose subject will be "Accountants' Limitations." Speakers at the banquet to be held at Del Monte on September 21st are yet to be announced, but the committee in charge of programme has promised that eminent men will be present.

# Income-tax Department

EDITED BY STEPHEN G. RUSK

Readers will find much food for thought and a keen interest in a decision made by United States District Judge Bodine, in the case *American Can Company; Missouri Can Company and Detroit Can Company, versus The United States* (published in the *Bulletin* of the American Institute of Accountants issued July 15, 1927).

This case comprehends the question as to how far the commissioner may exercise authority under the act of 1917 in directing how books of account shall be kept, if the method in use does not, in his opinion, reflect income. One should keep in mind that the ruling of the learned court appertained to the act of 1917, and that section 213(d) of that act provided as follows:

"A corporation . . . keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the commissioner of internal revenue, with the approval of the secretary of the treasury, make the return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income so returned."

In the case at issue before the court, it appears that the taxpayers had made their returns on the basis on which their books were kept, that this basis was presumably the accrual basis, but that the commissioner did not accept the returns so made in toto, but adjusted the taxpayers' inventories in such a manner as to increase on the accrual basis the taxable income. The taxpayers paid the deficiency asserted by the commissioner and then promptly filed claims for refund based on the theory that if the basis upon which these taxpayers kept their accounts and made their returns was rejected by the commissioner, the only alternative open to them was to compute their taxable income upon the basis of receipts and disbursements.

Upon this latter basis their combined taxable income was greatly reduced, as is revealed by a comparison of the income and profits taxes returned originally by the taxpayers on the accrual basis, with the same taxes based on cash receipts and disbursements. This comparison is as follows:

|                                | Original<br>returns | Cash basis     |
|--------------------------------|---------------------|----------------|
| American Can Company . . . . . | \$3,266,499.86      | \$2,514,478.94 |
| Missouri Can Company . . . . . | 15,213.54           | 7,449.89       |
| Detroit Can Company . . . . .  | 6,287.19            | 393.39         |
|                                | <hr/>               | <hr/>          |
|                                | \$3,288,000.59      | \$2,522,322.22 |

Here was a reduction of \$765,678.37 which the commissioner was obliged to accept because of the language of the statute. In addition to this, the treasury was obliged to refund additional taxes erroneously assessed and collected aggregating \$1,953,480.79—quite a tidy sum—all of which had to be paid back to these taxpayers with interest to date of judgment, because the commissioner's representatives were not satisfied with the valuation of the inventories

and because the language of section 213(d) of the act of 1917 "does not", as stated by the court,

"impose a tax upon the basis upon which the commissioner shall direct the books to be kept. The option is with the taxpayer to make the return upon the basis upon which its accounts are kept. The commissioner may reject the basis and levy the tax upon actual receipts and disbursements. He cannot in part reject and in part confirm the taxpayer's method of bookkeeping. If he could the tax might very well be an arbitrary adjustment reflecting anything but income."

As said before, this language is in the act of 1917, and between the time when this act was adopted and the date when the act of 1918 became law congress accumulated a fund of lore upon the subject of tax procedure and accounting practice, and in the act of 1918 it is provided:

"That net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books . . . , but if no such method of accounting is employed, or if the method employed does not clearly reflect income, the computation shall be made upon such basis and in such manner as in the opinion of the commissioner does clearly reflect the income."

No hampering restrictions upon the commissioner in that language, and not so much faith attributed to "the receipts and disbursements" basis.

There are numbers of our congressmen who would profit greatly by an intensive course of instruction in accountancy, if one is to judge their present state of information upon the subject by the views they hold upon such matters as, for example, taxing stock dividends. There seems to be no clearer way to demonstrate that a stock dividend does not imply a distribution of assets than to show the bookkeeping entry necessary to give effect to such a transaction.

#### SUMMARY OF RECENT RULINGS

The court has jurisdiction to alter, modify, or set aside, or disregard the commissioner's finding of the March 1, 1913, value of land without affirmatively showing error or fraud in the commissioner's determination. (Court of claims of the U. S., *John S. Kernachan v. The United States.*)

A partner may not deduct in his 1917 return a proportionate part of the partnership contributions to the American Institute of Accountants, either as a business expense or as a contribution to a corporation organized and operated exclusively for scientific and educational purposes. (Court of claims of the U. S., *Robert Montgomery v. The United States.*)

Dividends declared and paid in 1918, the 1918 earnings of the corporation at the time being in excess of all dividends declared and paid during 1918, are subject to surtax in the hands of the stockholder recipient. (Court of claims of the U. S., *Robert Clark Ream v. The United States.*)

Income received by an estate in 1919 which, by the terms of the will is permanently set aside for residuary legatees, non-taxable charitable and religious corporations, is deductible from gross income of the estate under section 219 (b) of the 1918 act, although not paid to the residuary legatees nor credited upon the books of the estate to them until 1923. (U. S. circuit court of appeals, second circuit, *Frank Bowers v. Executors of the Estate of Margaret Olivia Sage.*)

Goodwill is not subject to wear and tear and its loss through prohibition legislation may not be claimed as a deduction for obsolescence under section 214 (a) (8) of the act of 1918. (U. S. district court, N. D. California, S. D., *Landsberger v. McLaughlin, Collector.*)

A transfer made without consideration in 1912 to the natural heirs of the grantor, aged eighty-three, of more than two thirds of her entire estate, was

## Income-tax Department

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held to be a transfer in contemplation of death under section 402 (c) of the act of 1918. (U. S. district court, S. D. of N. D. California, *Executors of Estate of Christine F. Ringsdorff v. McLaughlin, Collector.*)

A corporation is liable for 2% of the tax on its bondholders when bonds provide for payment of principal and interest "without deductions for taxes which the company may be required to pay or retain therefrom by any governmental authority of the United States." (U. S. district court, S. D. of New York, *Roanoke Water Works Company v. Charles W. Anderson, Collector.*)

The amount of cash dividend declared in 1917, but never actually distributed, by a close corporation which at the time did not have and never set aside funds with which to pay it, was held to be invested, not borrowed, capital, even though the books showed a debtor-creditor relationship between the stockholders and the corporation and the payment of interest to some stockholders on the dividends declared. (U. S. district court, S. D. of N. D. California, *Haas Bros. v. John L. Flynn, Collector.*)

Amounts paid corporate officers by way of percentages of profits during 1916, 1917 and 1918, pursuant to an authorization in 1914, established by the taxpayer as reasonable bona-fide salary payments, are deductible as salaries paid for actual services rendered, in the absence of evidence by the government that such money paid was not salary but a distribution of profits. (U. S. court of claims, *William S. Gray Company v. The United States.*)

A taxpayer is entitled to a deduction for exhaustion of patent licence contracts, based on their March 1, 1913, value over their remaining life under the 1916 and 1917 acts. (U. S. court of claims, *International Curtis Marine Turbine Company v. United States.*)

A building and loan association organized and operating as such under state law is exempt under section 231 (4) act of 1918, and the provision of the 1921 act limiting the exception to such associations, "substantially all of the business of which is confined to making loans to members", does not apply under preceding acts. (U. S. court of claims, *Cambridge Loan and Building Company v. The United States.*)

The seller of an undivided one-third interest in a business receiving nothing for goodwill is entitled to deduct only one third the bonus paid for goodwill in the preceding year when he acquired his partner's interests in the business (65% of the whole) in the absence of evidence of the March 1, 1913, value of the remaining 35% of the goodwill. (U. S. circuit court of appeals, sixth circuit, *L. P. Brewer v. Robert Orr, Jr.*)

A gift in remainder for charitable purposes which may never ripen into possession is too remote, contingent and uncertain to be taken into account in determining the value of the net estate under the act of 1918. (U. S. court of claims, *Executors of Estate of Dellora R. Gates v. The United States.*)

Income received by a decedent within the taxable year from the beginning thereof to date of death is subject to tax under act of 1918, and is returnable by his executor or representative. (U. S. court of claims, *Executors of Estate of Augustus D. Julliard v. The United States.*)

The New York inheritance tax is not deductible from the gross income of the decedent under section 214 (a) (3) act of 1918. (U. S. court of claims, *Executors of Estate of Augustus D. Julliard v. The United States.*)

Non-interest-bearing notes of the chief stockholders of a corporation in excess of the salary, expenses and dividends to which they were entitled, were held not to constitute invested capital. (U. S. district court, district of Connecticut, *P. Garvin, Inc., v. Robert O. Eaton, Collector.*)

A bequest to an organization for the promotion of practical benevolence is exempt from the estate tax under the 1921 act. (U. S. district court, district of Connecticut, *Executor of Estate of Mary E. Scranton v. Robert O. Eaton, Collector.*)

The tax on corporations exercising the option in section 13 (d) of the act of 1917 of making its returns on the basis upon which the returns were kept must be levied upon the cash receipts and disbursements basis upon rejection by the commissioner of a return made on basis upon which the corporation accounts were kept. (U. S. district court, district of New Jersey, *American Can Company; Missouri Can Company; Detroit Can Company v. United States.*)



Decedent's gross estate should include, under the act of 1921, securities sufficient to yield the annuity, where the securities had been transferred over two years prior to death by the decedent to the grantees who contemporaneously (a) executed annuity notes payable to the grantor, during her life, and (b) transferred to trustee, in pledge of their annuity notes, the securities received from the decedent. (U. S. district court, W. D. Texas, *Eugene Tips v. James W. Bass.*)

A taxpayer is not precluded from setting up a ground for refund in an action to recover an estate tax different from that urged in the claim for refund, where misled by the commissioner's failure to specify completely deductions disallowed. (U. S. district court, district of Connecticut, *Executors of Estate of Mary E. Scranton v. Robert O. Eaton, Collector.*)

# 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 I (*continued*)

MAY 19, 1927, 1 P. M. to 6 P. M.

No. 3 (17 points):

The proprietor of a business receives from the bookkeeper a statement of net sales, profits and percentages of profits of five departments for two half-yearly periods.

He notices that each of the five departments shows a decreased percentage of profit for the second half year, in face of the fact that there is an increase in total sales and the total profit for the latter period is greater than that for the former.

With the idea that something might possibly be wrong, he asks you to review the figures and to give reasons for the apparent inconsistency.

Prepare your explanation in the form of a report from the statement presented, which is as follows:

#### *First half year*

| Department | Sales           | Net profit        | Percentage of profit |
|------------|-----------------|-------------------|----------------------|
| A.....     | \$8,750         | \$962.50          | 11%                  |
| B.....     | 19,800          | 1,485.00          | 7½                   |
| C.....     | 21,250          | 1,062.50          | 5                    |
| D.....     | 8,250           | 1,237.50          | 15                   |
| E.....     | 10,920          | 1,337.70          | 12¼                  |
|            | <u>\$68,970</u> | <u>\$6,085.20</u> |                      |

#### *Second half year*

|        |                 |                   |     |
|--------|-----------------|-------------------|-----|
| A..... | \$19,120        | \$1,912.00        | 10% |
| B..... | 10,870          | 760.90            | 7   |
| C..... | 8,080           | 363.60            | 4½  |
| D..... | 18,940          | 1,799.30          | 9½  |
| E..... | 15,830          | 1,899.60          | 12  |
|        | <u>\$72,840</u> | <u>\$6,735.40</u> |     |

*The Journal of Accountancy*

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*Solution:*

Mr. \_\_\_\_\_

*Dear Sir:*

We have reviewed the figures presented to us showing the sales, net profit and percentage of profit of your business, by departments, for two half-yearly periods.

As a matter of policy it would be well to verify the data in the statements prepared by the bookkeeper, for an error in the inventory at the end of the first half year would in itself affect the net profits of both periods.

Although each department shows a smaller percentage of profit during the second half year than during the first half year, the total sales, total net profit and percentage of total net profit to total sales are greater than for the first half year, as shown by the following summary:

|   | 1st<br>half year | 2nd<br>half year | Increase    |
|---|------------------|------------------|-------------|
| Total sales.....                                      | \$68,970.00      | \$72,840.00      | \$3,870.00  |
| Total net profit.....                                 | 6,085.20         | 6,735.40         | 650.20      |
| Percentage of total net profit to total<br>sales..... | <u>8.823</u>     | <u>9.247</u>     | <u>.424</u> |

The increase in the total net profit was due in part to the increase in total sales and in part to the increase in the average net profit, the latter being due to the greater proportion of sales made by the more profitable departments, A, D and E, as shown by the comparison of sales by departments for the two half-yearly periods (exhibit "A", page 137).

It will be noted that the increase in total sales was due entirely to increased sales by departments A, D and E, inasmuch as there were decreases in the sales of both department B and department C. Further reference to exhibit "A" shows that whereas for the first half year the sales of departments B and C comprised 59.52 per cent. of the total sales, the sales of those departments for the second half year were only 26.02 per cent. of the total sales. The proportion of total sales by departments A, D and E for the same periods increased from 40.48 per cent. to 73.98 per cent.

There is presented as exhibit "B" (page 138) a statement accounting for the variation in the net profit of each department and for the business as a whole. While the result for each department shows that net profit for the second half year tended to decrease because of a lower percentage of net profit, the aforementioned increase in the proportion of sales made by the more profitable departments led to an increase in the percentage of total net profit to total sales, the result being that for the business as a whole the increase in net profit of \$650.20 was due, to the extent of \$308.75, to an increase of .424 in the percentage of net profit, the balance of the increase being attributable to the increase in total sales.

Yours truly,

\_\_\_\_\_

*Students' Department*

| Department                  | NAME   |               |               |                      |               |                      |                      |                |                       |                |
|-----------------------------|--|---------------|---------------|----------------------|---------------|----------------------|----------------------|----------------|-----------------------|----------------|
|                             | Comparison of sales by departments for the half-yearly periods ended _____ and _____ |               |               |                      |               |                      |                      |                |                       |                |
|                             | Percentage of profit   |               | 1st half year |                      | 2nd half year |                      | Per-centage of total |                | Increase or decrease* |                |
|                             | 1st half year  | 2nd half year | Amount        | Per-centage of total | Amount        | Per-centage of total | In amount            | In per-centage | In amount             | In per-centage |
| B.....                      | 7.50   | 7.00          | \$19,800.00   | 28.71                | \$10,870.00   | 14.92                | \$8,930.00*          | 13.79*         |                       |                |
| C.....                      | 5.00   | 4.50          | 21,250.00     | 30.81                | 8,080.00      | 11.10                | 13,170.00*           | 19.71*         |                       |                |
| Total of B and C.....       |  |               | \$41,050.00   | 59.52                | \$18,950.00   | 26.02                | \$22,100.00*         | 33.50*         |                       |                |
| A.....                      | 11.00  | 10.00         | \$8,750.00    | 12.69                | \$19,120.00   | 26.25                | \$10,370.00          | 13.56          |                       |                |
| D.....                      | 15.00  | 9.50          | 8,250.00      | 11.96                | 18,940.00     | 26.00                | 10,690.00            | 14.04          |                       |                |
| E.....                      | 12.25  | 12.00         | 10,920.00     | 15.83                | 15,830.00     | 21.73                | 4,910.00             | 5.90           |                       |                |
| Total of A, D and E.....    |  |               | \$27,920.00   | 40.48                | \$53,890.00   | 73.98                | \$25,970.00          | 33.50          |                       |                |
| Total all departments ..... |  |               | \$68,970.00   | 100.00               | \$72,840.00   | 100.00               | \$3,870.00           |                |                       |                |

*Exhibit "A"*

|  | NAME             |                     |                   |                    |                       | Total              |
|--|------------------|---------------------|-------------------|--------------------|-----------------------|--------------------|
|  | Department A     | Department B        | Department C      | Department D       | Department E          |                    |
| Statement accounting for variation in net profit for the half-yearly periods ended _____ and _____ |                  |                     |                   |                    |                       |                    |
| Net profit—2nd half year   | \$1,912.00       | \$760.90            | \$363.60          | \$1,799.30         | \$1,899.60            | \$6,735.40         |
| Net profit—1st half year   | 962.50           | 1,485.00            | 1,062.50          | 1,237.50           | 1,337.70              | 6,085.20           |
| Increase or decrease* in net profit.....   | \$949.50         | \$724.10*           | \$698.90*         | \$561.80           | \$561.90              | \$650.20           |
| Increase or decrease* in net profit due to variation in volume of sales:                           |                  |                     |                   |                    |                       |                    |
| Sales—2nd half year...   | \$19,120.00      | \$8,080.00          | \$18,940.00       | \$15,830.00        | \$72,840.00           |                    |
| Sales—1st half year ...  | 8,750.00         | 21,250.00           | 8,250.00          | 10,920.00          | 68,970.00             |                    |
| Increase or decrease * Multiply by percentage of net profit for 1st half year.....                 | \$10,370.00      | \$13,170.00*        | \$10,690.00       | \$4,910.00         | \$3,870.00            |                    |
| Increase or decrease* in net profit due to variation in rate of net profit:                        | 11. % \$1,140.70 | 7.5% \$669.75*      | 5. % \$658.50*    | 15. % \$1,603.50   | 12.25% \$601.48       | 8.825% \$341.45    |
| Rate of net profit—2nd half year.....  | %                | %                   | %                 | %                  | %                     | %                  |
| Rate of net profit—1st half year.....  | 10.              | 7.                  | 4.5               | 9.5                | 12.                   | 9.247              |
| Increase or decrease * Multiply by sales for 2nd half year   | 11.              | 7.5                 | 5.                | 15.                | 12.25                 | 8.823              |
|  | 1.1*             | .5*                 | .5*               | 5.5*               | .25*                  | .424               |
| Increase or decrease* in net profit (as above) ...   | \$19,120.00      | 191.20* \$10,870.00 | 54.35* \$8,080.00 | 40.40* \$18,940.00 | 1,041.70* \$15,830.00 | 39.58* \$72,840.00 |
|  | \$949.50         | \$724.10*           | \$698.90*         | \$561.80           | \$561.90              | \$650.20           |

Exhibit "B"

## *Students' Department*

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No. 4 (17 points):

You are requested to make a balance-sheet examination as at December 31, 1926, of the A Company, engaged in the manufacture of machinery.

During your examination, you are informed that the inventory has been valued at cost, as reflected by detailed job-cost records on file. A study of the job-cost system, under which the inventory has been valued, indicates that factory burden has been absorbed in costs as a percentage of direct labor. The company's operating accounts tend to show that a considerable balance of unabsorbed factory burden has accumulated during the year, in spite of the fact that the plant was operated to capacity during the entire calendar year 1926.

(1) What are your conclusions regarding inventory valuation based upon the information cited above?

(2) What adjustment, if any, would you make in the total valuation of the inventory at December 31, 1926?

(3) If an adjustment in inventory valuation were necessary, how would you make it?

*Solution:*

(1) The inventory valuation based upon the information shown by the detailed job-cost records is incorrect in so far as it purports to reflect cost. It is assumed, of course, that factory burden as shown by the accounts includes no items not properly chargeable thereto and that, therefore, the accumulation of unabsorbed burden is the result of applying too small a percentage to direct labor in computing the amount of factory burden applicable to each job. That being the case, the cost of goods manufactured during the year, either wholly or in part, has been understated and the valuation of the inventory of finished goods and work in process is too low as a statement of the cost thereof.

(2) In order to show the actual cost, it is necessary to make an adjustment increasing the total valuation of the inventory at December 31, 1926, to an amount which will include the correct amount of factory burden applicable thereto.

(3) If it were desired to adjust only the total inventory valuation, the adjustment would be made by first determining the actual percentage of factory burden to direct labor for the period and applying that percentage to the direct labor represented in the inventory to ascertain the amount of factory burden which should have been included in the cost of the goods in the inventory. Then, by adding to the inventory valuation the difference between the correct amount of factory burden applicable thereto and the amount which has been included therein, the increased valuation will correctly state the inventory at cost.

Since the engagement involves only a balance-sheet examination as at December 31, 1926, it would not be necessary to investigate the correctness of the inventory at the close of the preceding year. Nevertheless, in view of the possibility that there may have been a similar error in that inventory, it would probably be advisable to invite the attention of the management to the matter, and to the fact that the detailed job-cost records on file are incorrect.

The cost of the goods sold would also be understated under the conditions described.

In the event that an income statement "per books" were to be prepared, the cost of goods sold should be adjusted. Otherwise it would not appear necessary to do more with respect to the portion of unabsorbed burden applicable to goods sold than to make certain that it be not included in the balance-sheet either as a deferred charge, as part of the inventory of work in process, or under any other caption.

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No. 5 (36 points):

On January 1, 1927, a corporation floated a bond issue of \$300,000 to be retired serially over a period of eight years as follows:

|                         |          |                         |          |
|-------------------------|----------|-------------------------|----------|
| Dec. 31, 1927 . . . . . | \$10,000 | Dec. 31, 1931 . . . . . | \$30,000 |
| “ “ 1928 . . . . .      | 15,000   | “ “ 1932 . . . . .      | 35,000   |
| “ “ 1929 . . . . .      | 20,000   | “ “ 1933 . . . . .      | 40,000   |
| “ “ 1930 . . . . .      | 25,000   | “ “ 1934 . . . . .      | 125,000  |

Discount and expense of issuing the bonds amounted to \$33,000.

Draft a schedule, showing how much of such bond discount and interest you would claim as a deduction from gross income, for federal income-tax purposes, for each of the years 1927 to 1934 inclusive.

*Solution:*

While the income-tax regulations permit as a deduction the amount of bond discount prorated or amortized over the life of the bond issue, no method is prescribed. The “bonds outstanding” method, which is commonly used in accounting practice, is used in this solution.

No interest rate is given in the problem, and an arbitrary rate of 5 per cent. is used to arrive at the amount of deductible interest.

Schedule of amortization of bond discount and expenses, and interest paid

| Year ended                  | Bonds<br>outstanding  | Fraction         | Discount<br>and<br>expense<br>amortized | Interest<br>at 5%<br>per annum | Total bond<br>discount<br>and<br>interest<br>deductible |
|-----------------------------|-----------------------|------------------|---|--------------------------------|---|
| December 31, 1927 . . . . . | \$300,000.00          | 300/1840         | \$5,380.43                              | \$15,000.00                    | \$20,380.43   |
| December 31, 1928 . . . . . | 290,000.00            | 290/1840         | 5,201.09                                | 14,500.00                      | 19,701.09   |
| December 31, 1929 . . . . . | 275,000.00            | 275/1840         | 4,932.07                                | 13,750.00                      | 18,682.07   |
| December 31, 1930 . . . . . | 255,000.00            | 255/1840         | 4,573.37                                | 12,750.00                      | 17,323.37   |
| December 31, 1931 . . . . . | 230,000.00            | 230/1840         | 4,125.00                                | 11,500.00                      | 15,625.00   |
| December 31, 1932 . . . . . | 200,000.00            | 200/1840         | 3,586.95                                | 10,000.00                      | 13,586.95   |
| December 31, 1933 . . . . . | 165,000.00            | 165/1840         | 2,959.24                                | 8,250.00                       | 11,209.24   |
| December 31, 1934 . . . . . | 125,000.00            | 125/1840         | 2,241.85                                | 6,250.00                       | 8,491.85  |
|                             | <u>\$1,840,000.00</u> | <u>1840/1840</u> | <u>\$33,000.00</u>                      | <u>\$92,000.00</u>             | <u>\$125,000.00</u>                                     |

No. 6 (36 points):

Corporation A has contracts with its sales and production managers whereunder each of the latter is to receive, as extra compensation, two and one-half per cent. of the net book profit of the company for the calendar year 1926, after providing for federal income taxes.

The net book profit for the calendar year 1926, before provision for the extra compensation and for federal income taxes, was \$95,000. There were, however, deductions amounting to \$5,000 included in the net book profit as stated above, which were unallowable for income-tax purposes.

From the foregoing data, compute the amount of federal income tax payable by the corporation and the amount of extra compensation due to each of the managers.

*Solution:*

Let B = the bonus (2 at 2½% each)

and let T = the tax

Since the bonus is to be 5% (2 at 2½% each) of the net book profit after providing for federal income taxes,

(1) B = .05 (\$95,000 - T)

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And since the tax is  $13\frac{1}{2}\%$  of the net book profit plus the unallowable deductions amounting to \$5,000 after deducting the bonus,

$$(2) T = .135 (\$95,000 + \$5,000 - B)$$

or (3)  $T = \$13,500 - .135 B$ .

Solving for B:

$$(1) B = .05 (\$95,000 - T)$$

or (4)  $B = \$4,750 - .05 T$

If we substitute the value for T in equation (3) for T in equation (4) we have:

$$(5) B = \$4,750 - .05 (\$13,500 - .135 B)$$

or (6)  $B = 4,750 - \$675 + .00675 B$

$$(7) B - .00675 B = \$4,750 - \$675$$

$$(8) .99325 B = \$4,075$$

$$(9) B = \$4,102.69$$

Then the bonus for each manager is \$2,051.35.

Solving for T:

$$(3) T = \$13,500 - .135 B$$

$$(10) T = \$13,500 - .135 \times \$4,102.70$$

$$(11) T = \$13,500 - \$553.86$$

$$(12) T = \$12,946.14$$

Proof

Method I:

$$(4) B = \$4,750 - .05 T$$

$$B = \$4,750 - .05 \times \$12,946.14$$

$$B = \$4,750 - \$647.31$$

$$B = \$4,102.69$$

Method II:

Computation of tax:

|   |              |
|---|--------------|
| Net book profit before deducting tax and bonus..... | \$95,000.00  |
| Add unallowable deductions.....                     | 5,000.00     |
| Total.....  | \$100,000.00 |
| Deduct bonus:                                       |              |
| Manager of sales department.....                    | \$2,051.35   |
| Manager of production department.....               | 2,051.35     |
|   | 4,102.70     |
| Taxable net income.....                             | \$95,897.30  |
| Multiply by.....                                    | 13½%         |
| Tax.....  | \$12,946.14  |

Computation of bonus:

|   |             |
|---|-------------|
| Net book profit before deducting tax and bonus..... | \$95,000.00 |
| Deduct tax.....                                     | 12,946.14   |
|   | \$82,053.86 |
| Profit subject to bonus.....                        | \$82,053.86 |
| Multiply by ( $2 \times 2\frac{1}{2}\%$ ).....      | 5%          |
| Bonus.....  | \$4,102.70  |



STOCKBROKERS' ACCOUNTS

*Editor, Students' Department:*

SIR: About a year ago you expressed a wish that there might be more discussion by your readers of the subject matter of your department. As a reader of several years' standing who has derived much benefit from the solutions which have appeared in your columns, I trust that the following comment on one of your recent solutions will be accepted in the spirit which gave birth to the aforesaid wish.

The solution to which I refer is given on pages 300 et seq. of the April issue and deals with the ascertainment of the financial condition of a firm of stockbrokers. Apart from the classification of the customers' accounts, the only adjustment that has been made relates to the valuation of the securities at the closing date. The solution does not show any investigation of the adequacy of the customers' margins or the adjustments necessitated by lack of adequate margin in any of the groups of accounts described in the problem. It appears to me that in the audit of a business of this nature the question of margins is of the utmost importance and I shall attempt to show wherein the collateral held by stockbrokers against "margin" trades of their customers requires different treatment from collateral held by other business concerns.

In the case of any of the customers' accounts mentioned under the headings (1) and (2) in the problem, the collateral held is not merely security for the debit balance but its market value also represents to the brokers as long as they are carrying the account a potential contra entry against the debit balance. Since the market value is always fluctuating, the brokers must continually weigh that value against the customers' debit balance in order to safeguard themselves against loss. The following are the three main factors which must be considered in the "weighing" process:

- (a) The debits to the customer's account, representing the purchase price of the securities bought for his account, together with the charge for brokerage and, subsequently, interest on the unpaid balance of the purchase price;
- (b) The cash deposited by the customer, representing a percentage of the purchase price of the securities;
- (c) The market value of the securities at any moment.

In the event of sale of the securities either on the instructions of the customer or by the exercise of the brokers' right under contract to sell in order to safeguard their interests in the face of adverse market conditions, "c" will become a credit to the customer's account. It is evident, therefore, that "b" should be of sufficient magnitude to insure that "b+c" will be in excess of "a." If, on the other hand, "a" exceeds "b+c," the brokers must have neglected either to obtain additional cash from their customer or to close the deal by the sale of the securities. They are consequently faced with a loss as it is unlikely that they can depend upon receiving further margin from the customer after he has already lost all the money he has deposited.

This is the condition which exists in the case of the customers' accounts with debit balances amounting to \$110,000. In this case, "a-b" is equal to \$110,000 and "c" is equal to \$90,000. The excess of "a" over "b+c" may be expressed as  $a - (b+c)$  or  $a - b - c$  which from the above data is  $\$110,000 - \$90,000$  or  $\$20,000$ . This means that there is a loss at June 30, 1926, of \$20,000 which the firm has incurred by not obtaining sufficient margin to safeguard itself in handling these transactions. In the course of his duties the auditor would naturally ascertain the brokers' reason for not closing out these trades, but in the absence of exceptional circumstances (of the existence of which the problem affords no indication) conservative accounting practice would dictate the creation of a reserve to provide against these losses. This would necessitate a charge against profits of \$20,000.

A similar condition exists in the case of the customers' credit balances of \$7,500. The firm has sold and delivered (from its own stock) securities for account of its customers and the accounts of the latter have been credited with the cash margins deposited and the amount of the selling price less brokerage. The customers, however, have not delivered the securities to the firm, and con-

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sequently the firm has a counterclaim against them equal to the market value of the securities sold "short." If "a" represents the selling price, "b" the cash deposited and "c" the market value of the securities, "a+b" should always exceed "c." In the present case "a+b" is \$7,500 but "c" is \$9,000 so a loss has been incurred on those deals of \$1,500. The firm has, of course, claims against its customers for the aggregate amount of this loss, but its chance of realizing the claims would ordinarily be slight. It is evident that the firm has been negligent in allowing these losses to occur and provision for a reserve of \$1,500 should therefore be made by a charge against profits of that amount.

The accounts described in the question under the headings (1) and (5) are adequately covered by margin while those mentioned under the headings (3) and (6) do not appear to represent open margin trades and their nature is not disclosed in the problem.

In order to show more clearly the firm's position in regard to securities owned and owing, I attach a statement showing a reconciliation of the securities "long" and "short" with the amount of \$495,500 which is stated to be the value of the securities owned by the firm. I also append a working paper showing a test of the status of the customers' margins which is arrived at by closing out (for the purpose of this test only) all the open trades at June 30, 1926. This paper shows the amount of losses on these trades to be \$21,500 which is the sum that I consider should be charged against profit and loss in order to provide for the aforementioned losses.

I am afraid that this letter has taken up more space than I intended but I hope you will not be too busy to give it whatever consideration it is due.

Yours truly,

WILLIAM MACINTOSH.

Vancouver, B. C.

SNOW FROST & Co.

Statement of securities "long" and "short" as at June 30, 1926

"Long"—

|   |                           |                |
|---|---------------------------|----------------|
| Securities in office and vault . . . . .                            | \$176,000.00              |                |
| Securities in transfer . . . . .                                    | 15,000.00                 |                |
| Securities deposited as collateral for bank loans . . . . .         | 190,000.00                |                |
| Securities held by other brokers for the firm's account . . . . .   | 1,955,000.00              |                |
| Securities due from customers on account of "short" sales . . . . . | { \$9,000.00<br>32,500.00 |                |
|   | 41,500.00                 | \$2,377,500.00 |

"Short"—

|   |                               |                |
|---|-------------------------------|----------------|
| Securities held as collateral for customers' accounts with debit balances . . . . . | { \$1,787,000.00<br>90,000.00 | \$1,877,000.00 |
| Securities borrowed from customers . . . . .  | 5,000.00                      | 1,882,000.00   |
| Net "long" (securities owned by firm) . .   |                               | \$495,500.00   |

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Test of margins on customers' open trades at June 30, 1926

|                                   | Ledger balances<br>represented by open<br>trades as per books |         | Adjustments to<br>close trades at<br>market value |             | Balances if trades<br>were closed at<br>this date |           |
|-----------------------------------|---|---------|---|-------------|---|-----------|
|                                   | Dr.   | Cr.     | Dr.   | Cr.         | Dr.   | Cr.       |
| "Long" accounts                   | \$1,337,500   |         |   | \$1,787,000 |   | \$449,500 |
| "Long" accounts                   | 110,000   |         |   | 90,000      | \$20,000  |           |
| "Short" accounts                  |   | \$7,500 | \$9,000   |             | 1,500   |           |
| "Short" accounts                  |   | 42,500  | 32,500  |             |   | 10,000    |
| Total loss on open<br>trades..... |   |         |   |             | \$21,500  |           |

"TRIAL AND ERROR" SOLUTION

*Editor, Students' Department,*

SIR: Will you kindly present solution of the following problem, using the "trial and error" arithmetical method rather than algebra:

Company (corporation) has an income of \$100,000 after deducting all expenses, before the calculation of departmental bonuses and income tax.

Department A is to receive a 10% bonus, after \$40,000 of the income mentioned.

Department B is to receive 5% after \$50,000 of income mentioned.

Department C is to receive 5% after \$80,000 of income mentioned.

By the term "after \$40,000, \$50,000, \$80,000 of the income mentioned" is meant that the bonus for each department is to be calculated on the basis of excluding these amounts from the base \$100,000 in figuring the bonus.

Both the bonus and the tax to be deducted before figuring the bonus.

Yours truly,

EDGAR M. PEEL.

Shreveport, Louisiana, May 21, 1927.

*Solution:*

The solution of the problem will be simplified by computing the total of the three bonuses and the total tax and subsequently dividing the total bonus into its three parts.

If it were not for the deductions of \$40,000, \$50,000 and \$80,000, applicable to the computation of the three bonuses, these bonuses would be as follows (representing the total bonus by B, the individual bonuses by Ba, Bb, and Bc, and the tax by T):

$$Ba = .10 (\$100,000.00 - B - T)$$

$$Bb = .05 (\$100,000.00 - B - T)$$

$$Bc = .05 (\$100,000.00 - B - T)$$

and the total bonus:

$$B = .20 (\$100,000.00 - B - T)$$

The deductions of \$40,000, \$50,000, and \$80,000 reduce the bonuses as follows:

$$A: 10\% \text{ of } \$40,000.00 = \$4,000.00$$

$$B: 5\% \text{ of } \$50,000.00 = 2,500.00$$

$$C: 5\% \text{ of } \$80,000.00 = 4,000.00$$

|       |             |
|-------|-------------|
| Total | \$10,500.00 |
|-------|-------------|

$$\text{Therefore, } B = .20 (\$100,000.00 - B - T) - \$10,500.00$$

$$\text{or } B = \$20,000.00 - .2B - .2T - \$10,500.00$$

$$\text{or } B + .2B = \$20,000.00 - \$10,500.00 - .2T$$

$$\text{or } 1.2B = \$9,500.00 - .2T$$

*Students' Department*

Table of repeated approximations

|  | First        | Second       | Third        | Fourth       | Fifth        |
|--|--------------|--------------|--------------|--------------|--------------|
| <b>Computation of tax:</b>                 |              |              |              |              |              |
| Net profit before bonuses                  | \$100,000.00 | \$100,000.00 | \$100,000.00 | \$100,000.00 | \$100,000.00 |
| Deduct bonuses                             | 7,500.00     | 5,835.42     | 5,797.97     | 5,797.13     | 5,797.10     |
| Remainder                                  | \$92,500.00  | \$94,164.58  | \$94,202.03  | \$94,202.87  | \$94,202.90  |
| Tax 13 1/4% thereof                        | \$12,487.50  | \$12,712.22  | \$12,717.27  | \$12,717.39  | \$12,717.39  |
| <b>Computation of total bonuses:</b>       |              |              |              |              |              |
| Bonus if tax and bonuses were not expenses | \$9,500.00   | \$9,500.00   | \$9,500.00   | \$9,500.00   | \$9,500.00   |
| Deduction for tax—20% of last estimate     | 2,497.50     | 2,542.44     | 2,543.45     | 2,543.48     | 2,543.48     |
| Remainder—120% of bonuses                  | \$7,002.50   | \$6,957.56   | \$6,956.55   | \$6,956.52   | \$6,956.52   |
| Bonuses—100%                               | \$5,835.42   | \$5,797.97   | \$5,797.13   | \$5,797.10   | \$5,797.10   |

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If the use of the literal notation in the foregoing statement of facts is regarded as algebraic, it could be avoided by the substitution of words which would result in the following statement:

\$9,500.00 minus two-tenths of the tax is equal to 1.2 times the total bonus.

On page 145 are the repeated approximations which constitute the solution by the trial and error method, the first guess of the amount of bonus being \$7,500, which is obtained as follows:

|  |            |
|--|------------|
| Amount of bonus if tax and bonus were not regarded as expenses . . . . .           | \$9,500.00 |
| Possible reduction resulting from treatment of bonus and tax as expenses . . . . . | 2,000.00   |
|  | \$7,500.00 |
| Remainder . . . . .  | \$7,500.00 |

No attempt is made to guess very accurately because any large error will be corrected in the first approximation. (Note that the \$7,500 is corrected to \$5,835.42 in the first approximation. This is a correction of \$1,664.58, and the amount of \$5,835.42 is within \$38.32 of the correct figure of \$5,797.10.)

Computation of bonuses

|   |             |              |            |
|---|-------------|--------------|------------|
| Bonus to A:                                 |             |              |            |
| Net profit before bonuses and tax . . . . . |             | \$100,000.00 |            |
| Deduct:                                     |             |              |            |
| Exemption . . . . .                         | \$40,000.00 |              |            |
| Total bonuses . . . . .                     | 5,797.10    |              |            |
| Tax . . . . .                               | 12,717.39   | 68,514.49    |            |
| Remainder . . . . .                         |             | \$41,485.51  |            |
| Bonus—10% thereof . . . . .                 |             |              | \$4,148.55 |
| Bonus to B:                                 |             |              |            |
| Net profit before bonuses and tax . . . . . |             | \$100,000.00 |            |
| Deduct:                                     |             |              |            |
| Exemption . . . . .                         | \$50,000.00 |              |            |
| Total bonuses . . . . .                     | 5,797.10    |              |            |
| Tax . . . . .                               | 12,717.39   | 68,514.49    |            |
| Remainder . . . . .                         |             | \$31,485.51  |            |
| Bonus—5% thereof . . . . .                  |             |              | 1,574.28   |
| Bonus to C:                                 |             |              |            |
| Net profit before bonuses and tax . . . . . |             | \$100,000.00 |            |
| Deduct:                                     |             |              |            |
| Exemption . . . . .                         | \$80,000.00 |              |            |
| Total bonuses . . . . .                     | 5,797.10    |              |            |
| Tax . . . . .                               | 12,717.39   | 98,514.49    |            |
| Remainder . . . . .                         |             | \$1,485.51   |            |
| Bonus—5% thereof . . . . .                  |             |              | 74.28      |
|   |             |              | \$5,797.11 |

Computation of tax

|                                     |              |
|-------------------------------------|--------------|
| Net profit before bonuses . . . . . | \$100,000.00 |
| Deduct bonuses . . . . .            | 5,797.11     |
| Remainder . . . . .                 | \$94,202.89  |
| Tax—13 3/4% thereof . . . . .       | \$12,717.39  |

## Book Reviews

HARMONY BETWEEN LABOR AND CAPITAL, by OSCAR NEWFANG.  
*G. P. Putnam's Sons*, New York. 238 pages.

The creed of the author of *Harmony between Labor and Capital* is set forth on the wrapper of the book as follows:

(The book)

"Sets forth the drawing-account wage, a new application of the partnership principle to industry. Workers would have a drawing-account or preliminary wage similar to the drawing-account of partners in a co-partnership; at the close of the year's business, after a fair dividend has been paid upon capital, the remaining earnings are to be allotted to workers, both managerial and manual, in proportion to salaries or wages. The preliminary wage is to be determined by free competition, but the final earnings of the workers will be whatever they can make the business earn above a reasonable dividend on capital.

To lay bare the causes of strife and to present a "comprehensive and final solution" of the problem of establishing harmony between labor and capital is the professed object of this book. Part 1, causes of industrial discord, is a presentation with which little fault can be found, although colored somewhat by an exaggerated idea of the extent to which capital dominates labor. Part 2, dealing first with employers' methods then with workers' methods of trying to establish industrial harmony, hits at both, severely and with effect. Throughout all this part of the book the author writes as though the division of income between capital and labor were such that capital received the great bulk of it. The opposite is the case. The amount paid in wages and salaries by the corporations of this country exceeds many times the amount of profit accruing to capital. In the year 1921, individuals reported income from dividends 2,476 million, and 13,813 million from wages and salaries; the majority of wage earners were not represented even in these figures, being tax exempt.

The present reviewer was for many years a member of a trade union, delegate to Central Labor Union, etc., and knows just how widespread among workmen is the idea that profits would suffice to increase wages by a large proportion. Mr. Newfang seems to have this delusion. Profits look large because they appear in bulk, but if distributed over all workers they become sufficiently small.

Mr. Newfang has succeeded very well in laying bare the causes of strife; prominent among them is the greedy character of the human animal, laborer or employer. Let us see what is his "final" cure.

This is summarized on page 108 as follows:

"Capital should be treated as a commodity for whose use a fixed rent should be paid, while labor should not be treated as a commodity. The workers should be treated as living human beings whose livelihood is more important than the surplus income of investors. A living for labor before dollars for dividends."

"At present capital is the 'residuary legatee,' to use an illustrative legal phrase in the division of receipts over capital costs, and labor is procured as a commodity at the lowest fixed price and figures into the cost of the product like any other commodity used in manufacturing. To reach the

true basis for industrial harmony it is necessary that this method should be reversed and that capital should be treated as a commodity to be procured at a reasonable rate per annum and labor should be the residuary legatee to whom all the remaining earnings of industry should go."

We may pass the inconsistency of the slogan "a living for labor before dollars for dividends" and the contention that first a reasonable rate be paid for capital and the residue given to labor.

In the year 1921, of all corporations in the United States of America, 48% had some net income and 52% had losses. Labor was paid in all cases. Does the author hold that the 52% of corporations having losses and the many corporations with profits less than enough to pay a normal return on capital should have treated capital as a commodity and paid a return thereon and that labor should have been the residuary legatee? Or is labor to be residuary legatee only where there is a sufficiently large residue?

Only capital can stand a year without income; it is substantially in the position of an insurer.

Even in the prosperous year 1925, 41% of all corporations had net losses; 430,072 corporations reported to the bureau of internal revenue, of which 252,334 had some profit and 177,738 had net losses.

The author does suggest (page 131) that the losses in any year should first be borne by the capital, but with a cumulative claim on future earnings, if any. What, then, about capital as a commodity and labor as a "residuary legatee"?

On pages 191 et seq. are given data showing how under the author's plan the whole property of certain of the largest and most solidly prosperous of American corporations might be conveyed to the workers. Unprosperous companies would never be acquired under the plan, unless some cruder mode of confiscation should be adopted.

Truly, the author points out the inequity of Marx and of the Bolshevik idea; but he seeks to arrive at the same result, namely, the transfer without consideration of capital to the workers. Nay, he is more unjust than these; he seeks to transfer to the workers all profits over a fixed return, thereby conveying to them in the end all profitable capital, leaving all unprofitable capital to the present owners.

There are knotty questions to be settled—what is a fair rate of return on capital, what is the actual amount of capital invested, what is the proper amount of compensation for risk of capital (differing for each enterprise) and many others, each, so far, without solution. Our author's resource is more law, more government regulation, even international agreements.

There is, on pages 110-113, a discussion of the rates to be allowed to capital, in which it is admitted that a universal rate is out of the question; but it is held that the rate at which bonds could be issued is a sufficient guide for fixing a basis. If labor should put up in cash as great an equity as now represents common stock and should guarantee the return to capital of principal and interest, perhaps a basis could be found; but instead of labor guaranteeing the return to capital (which we are told is a commodity and therefore to be paid for in cash) it asks this commodity to pay the "drawing account" of labor whether there are any profits or not. One who can think of capital voluntarily invested on such terms is to be congratulated on a brilliant imagination; I can not do it.

## *Book Reviews*

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We may gather from the author's childlike faith in the efficacy of government regulation that he is unsophisticated, and we may believe that he means well. There is a lamentable superfluity of books on economic and accounting questions by writers who mean well.

F. W. THORNTON.

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GOODWILL AND OTHER INTANGIBLES, by J. M. YANG. *The Ronald Press Co.*, New York. 232 pages.

The increased interest shown in recent years in the accounting problems arising in connection with so-called "intangible" property makes Dr. Yang's work a welcome addition to accounting literature and those who have an interest in these problems will find the book extremely thought provoking.

The book begins with a rather searching analysis of the concept of property with particular reference to the time-worn classification of property as between tangible and intangible. The elements entering into the make-up of goodwill are then considered from the psychological, economic and legal viewpoints. Similar analysis follows for other classes of intangible property, including trademarks, patents, franchise, going value, etc. The first half of the book ends with a discussion of goodwill value as related to excess earning power and the problem of imputing excess earning power to specific intangibles. The chief value of this section of the book lies in keenness of its analysis and the stimulating character of the discussion. If any criticism is to be made, the reviewer wishes that Dr. Yang had taken the final step and conceded that all property is "intangible" in the sense that basically it consists of rights, powers and privileges given and guaranteed by society. Property consisting of land is an "intangible" including among other things the exclusive privilege to use, the power to transfer and the right to keep others from trespassing. The distinction sought to be made as between tangible and intangible property will never be clear until it is approached in this manner and "intangible" property, as it is now defined, shown to be merely rights, powers and privileges of a somewhat different type as compared with the rights, powers and privileges classified as tangible property.

The second half of the book deals specifically with accounting problems including the treatment on books of account of intangibles, purchased and non-purchased, with a final chapter on intangibles in partnership and corporate reorganizations. The discussion here covering only 120 pages is by no means exhaustive and leaves some of the accounting problems unmentioned. The chief criticism of this section lies in the fact that the author fails to develop clearly the purposive nature of value and the different kinds of value which may be used in a single situation depending upon the purpose to be achieved. The reviewer finds no difficulty with the proposition that a given asset may have more than one value and that the value to be used may depend upon the particular purpose which the statement is intended to serve.

The chief merit of the book lies in the fact that it stimulates one's thoughts on a subject of more than passing interest. From such stimulation progress toward the solution of these problems is bound to follow. The book should be read by every accountant.

JAMES L. DOHR.



SURVEY COURSE OF ACCOUNTING, by WESLEY JAMES McCARTY and L. CLEVELAND AMIDON. *Prentice-Hall, Inc.*, New York. 483 pages.

*Survey Course of Accounting* is a text designed for the use of colleges and university departments which do not offer extensive instruction in accounting. It contains a large number of demonstrations and exercises for the student to solve. Only 200 of the total 469 pages are devoted to general discussion of the principles illustrated. The title of the book suggests that all the important subdivisions of accounting theory and practice will be presented. The requirements of such a programme compel the authors to make rather short shrift of some topics. The subject of constructive accounting is dealt with in chapter twelve. The first two paragraphs read as follows:

"1. *Constructive Accounting*.—Constructive accounting is that branch of accounting which embraces the study of a business enterprise, that its needs, in respect to forms, books, titles of accounts, form of exhibits, et cetera, may be determined and acquired either by purchase, or by submitting sketches to a printer and having them made to order.

"2. *Drawing Forms*.—Practice in drawing forms for journals will be had by duplicating the purchase, sales, cash receipts, cash payments, and the general journal, as used in chapter X, in the accounting for M. P. Scott. One form should be placed on a page; and the various forms fastened within a cover, in book form."

The remainder of the chapter (approximately four pages) introduces an exercise, the solution of which requires the use of specialized journals. Students in the arts and sciences are prepared to analyze the basic theories underlying accounting. In view of the purpose of the text, it would seem that the theoretical portions might well be extended and the demonstrations reduced.

In the preface the authors state that "a new method is presented in this text. . . . This course is built upon the 'equation' which, as such, is easily and universally understood, but which, apparently, heretofore has been regarded as incidental to accounting, and not as the foundation upon which the science is built." (p. iv.) This statement puzzles one in view of the fact that complete theories of debit and credit have been developed from such well known equations as "assets equal equities"; "assets equal liabilities plus proprietorship"; "assets equal ownership-claims."

C. RUFUS ROREM.

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FEDERAL INCOME TAXES, 1927, by ERIC L. KOHLER. *A. W. Shaw & Co.*, New York. 542 pages.

Mr. Kohler's contribution to federal income-tax bibliography is addressed principally to the "beginning student" and "does not attempt to compete with the larger handbooks and manuals to which the trained practitioner has reference." For the student of taxation, this book is admirable in the complete and interesting manner in which its lore is set forth and demonstrated. The trained practitioner, too, will find the book interesting, especially when he observes the problems that are given for solution. These problems cover almost the entire range of tax questions upon which any sort of authentic ruling has been made. The answers to the problems are not given, but people having experience will recognize on reading the questions that they have seen, somewhere, the same problems solved by the courts, the treasury department or by the board of tax appeals.

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It seems proper to state, as has the author in his preface, that little is developed upon such matters as depletion, taxation of insurance companies, non-resident aliens, withholding at the source. The author holds that these matters are not of general interest.

Among the matters discussed in this book, which will appeal to tax practitioners, are the paragraphs setting forth the dates of the several acts, as well as the effective dates of many of the taxes imposed in the acts. To many of us the question as to when a certain provision became effective is one that causes much painstaking search and consumes much valuable time in solving. It is probably unnecessary to detail the plan by which this subject is developed by the author. It is sufficient to state that after a brief review of federal income taxation of the past eighteen years, the subject is developed in much the same sequence as that in which the 1926 act is written. It is fully indexed.

There may be those who question whether or not the subject of invested capital is of any current value, as the statute of limitations has become effective upon taxation of the years in which excess and war profits taxation was imposed, but to those who are still confronted by problems for those high tax years, this book will furnish information that will be found helpful. I wonder if others have found the same difficulty, in computing taxes under the acts of 1917 and 1918 in these later years after having forgotten the intricate methods by which the solution was found. When the question appeared as to what limitation upon the tax was provided for by section 302 of the act of 1918, my reaction was about the same as it is when one meets an old acquaintance whose name will not come readily to mind.

STEPHEN G. RUSK.

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MATHEMATICAL PRINCIPLES OF FINANCE, by FREDERICK C. KENT.  
*McGraw-Hill Book Co. Inc.*, New York. Second edition, 400 pages including tables.

The first edition of *Mathematical Principles of Finance* was reviewed in *THE JOURNAL OF ACCOUNTANCY* of July, 1924, and the ten-place tables, recently published separately but now incorporated in the volume, were reviewed in *THE JOURNAL* of January, 1927. The new edition in combined form makes an excellent reference book for any accountant. The introduction to the second section containing the tables gives sufficient examples so that a knowledge of actuarial science is unnecessary for all ordinary purposes. The first 174 pages contain the theory of compound interest and its applications, including chapters on logarithms, depreciation, building and loan associations, the federal farm loan board. There are three chapters on life insurance.

For students with a thorough knowledge of elementary algebra the text should present no great difficulties, although in places it makes hard reading which might have been avoided through a little more "padding." In some cases, in order perhaps to shorten the arithmetical work, a formula is transposed to a different form, although by doing so the obvious reason for the original equation is lost. It is sometimes easier to make two calculations than one and much easier to remember a formula of two elements which mean something than a formula of one element the meaning of which cannot be read from its face. In other cases common sense is more easily applied than an algebraic

formula. However, these are minor criticisms of a work which contains remarkably few errors and shows great thoroughness and care in its preparation and is a valuable addition to the literature on the subject.

EDWARD FRASER.

**BANK AUDITS AND EXAMINATIONS**, by JOHN I. MILLET. *The Ronald Press Co.*, New York. 490 pages.

"The average board of directors is composed of men of affairs who could not afford to devote the required time to make a complete examination."

"The usual directors' examinations fail of their real purpose for the following reasons:

- " 1. Inattention to detail
- " 2. Lack of technical training
- " 3. Lack of time."

These words of the author of *Bank Audits and Examinations* emphasize the necessity of bank examinations by trained examiners and his book can well be used as a reference book by bank examiners to see what work can be performed to conduct a thorough, complete and detailed audit of a bank and its operations. After a short outline of bank organizations and a preliminary survey of a bank, the reader finds himself in one department after another making a complete and detailed examination of all assets and liabilities, earnings and expenses that are discussed. Then follow the usual criticism of examinations made by directors, suggestions regarding the audit programme to be adopted before the examination is undertaken, suggestions regarding preparation of statements and reports and the use of ratios and an outline of internal control. The book closes with a presentation of a few provisions of banking laws and a fourteen-page index.

The bank auditor will be disappointed to find little about his internal work and the bank examiner to find a maze of detail which can be used only in exceptional cases. Few directors will be found willing to pay the cost of an examination as extensive as described. The book lacks logical sequence and proper editing. Chapters 28 and 29 should have found a place in the beginning, since the programme must be prepared before the examination is started and should be approved by the board of directors or the examining committee. There are many and good suggestions in the chapters dealing with examinations, but there is little excuse for the numerous errors and hazy statements which should not appear in a technical book. For instance, on page 187 reference is made to the "contingent liability of the bank acceptances; for the bank is required to pay, whether the customer is in a position to repay the bank or not." The words themselves show that this direct liability is a very actual liability, as every banker knows.

In chapter 18, two methods are shown how a defaulting teller could cover a shortage charged against certified cheques, but both methods would create a double difference and not cover the shortage.

In the statements shown in chapter 30, a number of lines are misplaced or superfluous, and figure 57, a form of statement recommended to accountants, shows acceptances as contingent liabilities, and contingent assets and liabilities among the direct assets and liabilities, contrary to accounting and banking principles, while the statement recommended by the federal reserve board and supported by the American Institute is missing.

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Chapter 31 could have been omitted to the advantage of the reader. It is full of meaningless remarks and written in such unintelligible language that even the author might find it difficult to explain what was in his mind. Progressive banks have been using ratios and statement analyses for many years and about fourteen different ratios are calculated and compared with the averages published regularly by the reserve bank.

The appendix contains a jumble of extracts of banking laws and the index is incomplete and carelessly prepared.

CHRISTIAN DJORUP.

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AUDITING PROCEDURE, by WILLIAM B. CASTENHOLZ. *LaSalle Extension University*, Chicago. 430 pages.

The recently issued edition of *Auditing Procedure* is the second. The first was published in 1918. In addition to the 430 pages of text, there are illustrative audit working papers which purport to be typical of an average engagement. This book is written rather more interestingly than the average volume on auditing. One of its features is a list of questions at the end of each chapter entitled "Test yourself on essential points." Many of these questions are taken from C. P. A. and American Institute examinations.

The first twenty-four chapters are given over to an explanation of the method of auditing balance-sheet, income, and expense accounts of the average business. The remaining chapters discuss, principally, the essential features in audits of special business types. An unusual number of special businesses is discussed in these chapters and the important points in each have been brought out very clearly. The section of the book containing these chapters is particularly interesting and helpful.

In chapter 6 the author advocates that prepaid expenses be distinguished from deferred charges, and that they be included as a separate item in the balance-sheet, immediately following current assets. The question of whether or not prepaid expenses and deferred charges should be separated and shown under separate headings has resulted in considerable discussion among accountants in the last few years. In the opinion of this reviewer, the question is unimportant, but inasmuch as the items coming under each heading are somewhat similar, it seems unnecessary to attempt to classify them separately. The federal reserve board, of course, advocates including them under one heading. It is evident that in the author's own mind the line of demarcation is not altogether clear. For example, in one place he states that prepaid insurance (presumably computed on the short-rate basis) should be included in prepaid expenses rather than deferred charges, while in a later chapter he remarks that capital invested in fixed assets resembles prepaid insurance, in that it is a deferred charge to future operation.

The author very wisely stresses the necessity of verifying the income-producing accounts. He remarks that "many auditors are so engrossed with the task of assuring themselves that all expenses have been properly accounted for, and that all assets and liabilities are correctly stated in the balance-sheet, that they overlook to a very large extent the income-producing accounts." This point is well taken and should give more than one reader cause for reflection. In view of the author's comments it is rather odd that the work programme, which forms a part of the audit working papers submitted as addenda, does not

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indicate that any particular attempt was made to verify income from sales, and that no schedule supporting the sales account is included.

W. B. FRANKE.

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BANK SYSTEM AND ACCOUNTING, by FRANK LOOMIS BEACH. *The Ronald Press Co.*, New York. 359 pages.

The author of *Bank System and Accounting* has evidently gone to a great deal of trouble in collecting information as to various systems used by banks in different parts of the country in their various departments. In all he presents ninety-six illustrations of forms in use and accompanies them by ample narrative explaining their use. It is noted that this volume confines itself for the most part to describing various systems in use without attempting to explain in what circumstances each is most appropriate. Accordingly, the inexperienced reader, who is looking for advice, would have difficulty in arriving at the proper conclusion. There is a further danger in using certain of the forms, particularly the form of note which is most probably adaptable only to one particular state. Before any such form is used by a bank, it should be ascertained that the requirements of the state in which the bank does business are complied with. The author is to be congratulated in having provided a very interesting comparison of systems and practices, which he has found to be in force.

ANDREW STEWART.

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JUNIOR ACCOUNTING, by SAMUEL F. RACINE. *The Western Institute of Accounting, Commerce and Finance*, Seattle. 236 pages.

*Junior Accounting* is a text-book for the student in accounting and a manual for the junior accountant to guide him in making audits by standard procedure as prescribed by the federal reserve board in its *Bulletin* of April, 1917. Its most valuable and practical feature is that, beginning with chapter 6, the author heads each chapter with an excerpt from the *Bulletin* covering the subject of that chapter—verifying cash, inventories, etc.—and follows it with more details and explanations of working procedure. While the *Bulletin* merely outlines to the trained auditor what should be done, Mr. Racine tells the neophyte further how to do it. An appendix contains pertinent problems and quizzes on each chapter.

W. H. LAWTON.

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ARITHMETIC FOR BUSINESS, by BENJAMIN B. SMITH and CHARLES R. HILL. *Ellis Publishing Co.*, Battle Creek, Michigan. 391 pages.

A text book for schools requires but little comment in these columns. *Arithmetic for Business* is written, as its title implies, for the use of boys about to enter a business career and appears to cover very thoroughly the whole subject from simple arithmetic onwards—including the meaning and use of voucher cheques, financial statements, graphs, stock-exchange quotations, bond tables, compound-interest tables, taxation and insurance. It is copiously illustrated with examples. It is not one of those books dealing in short cuts and has the merit of insistence on thorough knowledge of the fundamentals before proceeding to the next step. It is an excellent book for the purpose intended.

EDWARD FRASER.

## *Book Reviews*

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AUDIT NOTE BOOK, No. 3. *Gee & Co.*, London. 49 pages.

NO. 4 AUDIT NOTE BOOK. *Gee & Co.*, London. 30 pages.

Mr. Pixley in his *Duties of Auditors* (eleventh edition, page 447) states that "a note-book should be kept for each audit for recording entries relating to the details of the audit, . . . The note-book should be filed with the papers relating to each periodical audit." "In the note-book should be recorded, in as few words as possible, the work performed day by day on the audit by the auditor and his staff. The note-book serves a double purpose, firstly, the managing clerk can satisfy the auditor as to his having efficiently checked the details, and, secondly, it is a proof of the care exercised by the auditor, which can be produced later on should any charge be made against him of not having performed his duties in a satisfactory manner."

These note-books are similar to others which have been in general use, we understand, among English professional accountants for years past. Book No. 3 attempts, however, to provide for audits of a less straight-forward character, and also those relating to comparatively unusual types of business. This book provides space for various memoranda regarding the books of account, the verification work done on each and by whom, and other special matters relating to the audit. An interesting part of the note-book relates to the provision for various comments to the principal on such points as the system of internal check and organization generally, the receipt of monies, the passing of invoices and credit memoranda, the supervision of petty cash, the method of stock-taking, the general state of the books, compliance with statutory requirements, sufficiency of working capital and any other matters requiring special comment.

Several pages are provided for "notes and queries"; there are also sixteen pages of ordinary four-column working paper for including various special matters or summarized groups of figures. By the use of such a book it is intended to reduce the number of separate papers in an audit to a minimum.

*No. 4 Audit Note Book* is, in effect, a programme of audit. Rather detailed instructions are given regarding the verification work to be done, and ample space is provided for notes, for additions to the audit programme, and so forth. The forms of certificates to be obtained from officers or employees relative to inventories, capital assets, cash balances, etc. are also suggested.

While it is not probable that such note-books will ever find extended use in the United States, they are nevertheless interesting to the American practitioner both in showing what is being done by practitioners in Great Britain and also for their concise summary of audit procedure. These note-books may well be added to every accounting library.

J. HUGH JACKSON.

## Current Literature

Compiled in the Library of the American Institute of Accountants

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

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