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Valuations for Tax Purposes*

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There will always be a considerable difference of opinion in each profession as to the proper jurisdiction of that profession. This problem of jurisdiction has been constantly before each of the learned professions in all the eras of their development. Centuries ago when Francis Bacon, Lord Verulam, was chancellor of the exchequer a young nobleman ventured to elope with the chancellor's daughter. The chancellor, oblivious of his duties to the royal conscience, so far forgot his own jurisdiction as to surround himself with an armed band of retainers and start in hot pursuit. Whereupon many of the royal army officers and royal navy officers so far forgot their duties to their sovereign as to rally to the support of the elopers. A pitched battle would have developed if a prelate had not so far forgotten his jurisdiction as to marry the young people illegally. In the tight little island of England this long series of illegal acts by the most prominent people of the realm naturally resulted in litigation during the course of which the learned justices delivered themselves of the legal axiom, "It hath been our experience that professions do constantly tend to enlarge their own jurisdictions."

While I can not vouch for the historical accuracy of this legal aphorism, it does contain a large grain of truth and that grain might well be meat to our own profession. The physician does tend to become the dictator of public-health laws, the lawyer does tend to become a counsellor in economics, the engineer does tend to deliver himself of accounting opinions, the dentist becomes an oral surgeon and the men of the church involve themselves in public policies and politics. Whether because of his native modesty or, God save the mark, because of his limited education, the professional accountant has tended to limit his profession rather than to enlarge its jurisdiction.

Nowhere is this tendency of the professional accountant to deny his own salt more evident than in the exceedingly important

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field of valuations for tax purposes. Far from attempting to enlarge his jurisdiction, the professional accountant seems to be needlessly anxious to give away ground that properly is his.

A striking illustration is found in the field of inheritance taxation. In October, I was a member of the committee that arranged the programme of the regional meeting of the American Institute at Chicago. The chairman of the committee very wisely decided that our programme should include a discussion of the relation of the public accountant to inheritance-tax returns and, perhaps unfortunately, delegated to myself the duty of interviewing a well known firm of lawyers in Chicago, prominent in inheritance-tax work, with the request that a member of that firm address our regional meeting. The members of this firm gave my invitation attentive audience and asked for a period of three weeks in which to consider the invitation to furnish such a speaker. At the end of three weeks I was informed that this firm had reviewed its extensive practice in the field of inheritance taxation and could not discover that there was any relation existing between the professional accountant and the field of inheritance taxation. This led me to make inquiries among my own professional brethren and I discovered, to my surprise and rather to my chagrin, that inheritance-tax returns, and particularly inheritance-tax valuations had not occupied a very large part of the attention of several of the more learned of Chicago's professional accountants.

Any sort of consideration of the problems raised by federal and state inheritance taxation discloses at once that the most serious problems in inheritance-tax administration have to do with the valuation of the different assets and liabilities that are exhibited in the estate. Certain of these assets can well be valued by practical business men. For example, real estate, real-estate leases and real-estate mortgages may be, and are properly, the subject of appraisal by real-estate men and/or professional engineers. Buildings and fixtures, as well as many kinds of machinery, are properly appraised by professional engineers. Choses in action may properly be appraised by attorneys, particularly when the choses are in litigation, or likely to suffer litigation before their final determination. All the other items comprising any estate are items requiring for their valuation the education, professional training and professional experience of the practising professional accountant.

Let us take for purposes of illustration securities such as bonds and stocks.

When the securities are actively dealt in on the market, the average price for a reasonable period before and after death is the best measure of value (*Matter of Crary*, 31 Misc. 72; 64 Supp. 566; *Matter of Proctor*, 41 Misc. 79; *Matter of Chambers*, 155 Supp. 153).

In New York the statute requires this basis of appraisal (see decedents' estate law, 122).

This is so even though the estate holds large blocks of stock which might depress the price if sold all at once.

In discussing this question, the Illinois court says in *Walker v. People* (192 Ill. 106, at page 110; 61 N. E. 489):

> "Fair market value has never been construed to mean the selling price of property at a forced or involuntary sale. The very fact that the market would be depressed by forcing such large blocks of stock to sale indicates that such sale is not a proper test of the fair cash value of the stock. . . . The quotations of the stock exchange may be temporarily uncertain and untrustworthy if the sales thereon are suddenly affected for speculative purposes or by the forcing upon the market and to sale of large blocks of stocks in an extraordinary manner with no explanation of such action and when the purpose of it is left to the conjecture of those dealing in the stocks; but such a quotation may be a fair and safe guide when they are taken for a reasonable period of sales made in the usual and ordinary course of business."

However, in the case of securities actively traded in on the New York stock exchange the market value at the time of death may not be a proper valuation because the amount of the securities held by the particular estate may be either so large or so small that sale on a given date on the stock exchange would in itself create a different market value than the prevailing ticker quotations. Thus the court said in *Matter of Gould* (19 App. Div. 352; 156 N. Y. 423, 51 N. E. 287):

> "It is claimed, however, that the rule should be construed that when the value of large blocks of stock is involved, only the purchase and sale in markets of correspondingly large blocks of stock should be considered, upon the theory that such large blocks would necessarily sell at lower rates than small quantities of stock sold separately, and that throwing large blocks of stock upon the market all at once would have a tendency to produce a break in the market and perhaps an inability to get more than a mere nominal price offered for that stock. Under the construction contended for the securities involved in this proceeding might have been shown to be of little or no value."

Continuing our illustration, let us give some thought to inactive securities and their valuation. In the preparation of capital-stock-tax returns professional accountants have become thoroughly acquainted with the difficulties of giving proper valuations to securities of corporations where the securities are closely controlled, or where the corporation is small, or where the securities represent a minority interest in a subsidiary corporation. It is interesting to note that it was recently held in California that:

"The fact that minority stock was converted into majority stock by its transfer from the deceased to the beneficiary, who was also a large stockholder, did not affect the appraised value. This must be determined, as in other cases of closely held stock, by the value of the property of the corporation which the shares of stock transferred represented."—(*Felton's estate*, 176 Cal. 663; 169 Pac. 392.)

In the case of inactive securities the prevailing rule of valuation for inheritance-tax purposes is that the intrinsic value from the assets and debts must be ascertained (*Matter of Achelis*, N. Y., L. J., March 9, 1912).

While the practice varies as between federal inheritance-tax administration and state inheritance-tax administration and varies again as between the various states, the usual practice seems to be for an appraiser to be appointed to make a valuation of inactive securities. Naturally, the appraiser refers to the books of account of the corporation showing the securities and to similar kinds of evidence in making the appraisal. Often the appraiser discovers some very interesting conditions in corporate practice. While I do not wish unduly to lengthen this discussion, I am tempted to quote the remarks of the learned surrogate in *Matter of Pancost* (89 Misc. 110, 152 Supp. 724):

"This appeal by the executor of decedent's estate brings up for review the finding of the appraiser as to the value of the shares of stock in the Jersey City Galvanizing Company held by the decedent at the time of his death. It is conceded by the executor that the statement of assets and liabilities of the company which is attached to the appraiser's report is a correct transcript from the books of the company. If the valuations contained in this statement were correct, the book value of the stock would be about $186.00 a share. The president of the company testified, however, that the value of the assets as entered on the books of the company was not correct, that the values were 25% to 50% higher than the actual values, and that they were retained on the books for the purpose of assisting the company in obtaining credit.

"When the corporation wishes to obtain credit, it refers to its books which show net assets of $149,022.00, or a value of $186.00 a share. When the state attempts to assess a tax upon the interest of a stockholder in the company, the president of the company testifies that the actual value of the assets is about 50% of the book value, and that the value of the stock is only about $50.00 a share. I regret to say that in law little credence can be given to the evidence of persons who make such admissions of deliberate misrepresentation. There may be extenuating facts not presented of record. It is difficult for the surrogate to reconcile the conflicting statements of value and, therefore, it is practically impossible to arrive at a valuation that is more than approximately correct. The testimony in regard to alleged sales of stock is not conclusive, as such sales were not made in the open market, and the price at which the sales were made five years after the death of the decedent can not be taken into consideration in a proceeding to ascertain their value at the date of his death. I can not, therefore, find from the evidence in this matter that the appraiser's valuation of $125.00 a share is excessive. The order fixing tax will be affirmed." *

It is not my present intention to enter into a discussion of the legal aspects of valuations for inheritance-tax purposes. My purpose here is to suggest to the profession that such valuations as are required for tax purposes should be made by the professional men whose training and experience best qualify them for such judgment. The real-estate man is the proper appraiser of real-estate values, the engineer is the proper appraiser of fixed assets, the lawyer is the proper appraiser of the probable results of litigation, the accountant is the proper appraiser of all assets and liabilities whose appraisal must be determined from the inspection of records of accounts.

Take the matter of the valuation of inventories. An important aspect of inventory valuation is the classification of the items of the inventory as between (a) active, (b) inactive, and (c) obsolete items. The distinctions in this classification are judgments arising from the actual records in the business relative to the turnover of the items in inventory. This certainly is a matter strictly within the jurisdiction of professional accountancy. Similarly, the counting of quantities of a large inventory is a matter involving records and internal audits, and the determination of what shall constitute price is an economic determination which should be left to the profession of applied economics, i.e., the accounting profession. Were I addressing laymen I might need to illustrate this question of price, as many of the laity, including in this respect attorneys and even judges, fall into the fallacy of assuming that price is readily ascertained for any given date. Professional accountants need no instruction as to the extremely technical character of the work required to determine the price as at a given date of the items comprising finished goods ready for the market. And when one essays the task of fixing price on work in process and on raw materials in stores there are few partners in the most important of professional accounting firms who will not admit that such work requires the utmost of their professional judgment and skill.

Let us pause then to consider how inventories are valued for inheritance-tax purposes. These values are largely made by lawyers learned in the law, or by mechanical engineers trained in the stress and strain coördinates, or even by real-estate men whose

* This matter of the valuation of inactive securities for inheritance-tax purposes is ably discussed in *Inheritance Taxation and the Federal Estate and Gift Taxes* by Gleason and Otis. (Matthew Bender & Co., New York, 1925.)

boast is sometimes that they have not been educated at all. Obviously, the professional accountant should exercise jurisdiction in the valuation of inventories for inheritance-tax purposes.

In the case of inventories there may be a very small margin of reason for valuations by professional engineers, particularly where the professional engineers can claim a working knowledge of the principles of cost accounting. There is not even this margin of reason for valuations other than by accountants in such estate items as goodwill, accounts receivable, notes receivable, funds held in trust and the whole list of payables and reserves. All of these items of value, positive and negative in the determination of the net estate, are items whose intrinsic worth must be determined from the professional inspection of accounts and records.

The whole matter seems so plain from the standpoint of the professional accountant that the question may well be raised why the valuation of estates is not normally and almost automatically turned over to the professional accountants in America as it has been to a large extent in Great Britain. One suggested answer is that trust companies often administer estates and have their own professional accountants within their organization, or perhaps are unwilling that professional accountants should share in the large fees that the trust companies enjoy. This suggested answer might also apply to prominent attorneys who have a good reputation in the administration of estates and see no particular reason why they should share fees with professional accountants. I do not myself believe that the trust companies and attorneys have any particular anxiety to keep professional accountants out of this business. It is rather my conviction that professional accountants in America have not in most cases justified themselves to the trust companies and to the attorneys as capable professionals in valuations.

The second suggested explanation of the dearth of this work among accountants may well lie in the distaste that the accountants themselves have for work involving appearance as witnesses, subject to examination and cross-examination. Many accountants have unhappy recollections of their experiences on the witness stand and some of them may therefore refrain from giving opinions on values which are subject to examination and cross-examination.

At this point I should like to say that accountants, as professional men, should become more expert in giving evidence and particularly in the preparation of evidence. It is a familiar rule of law that, subject to certain limitations, there are many occasions when original entries in books of account are best evidence. Unfortunately, most of the decisions of courts of last resort in this particular have to do with such simple forms of books of original entry as the now obsolete day-book and journal. The accountant realizes that the books of original entry today in any large corporation are exceedingly complex in character, including as they do loose-leaf records, card records, adding-machine tapes, columnar distribution records, tabulating cards, hectograph factory tickets, etc.

The problem of giving evidence based on books of original entry is difficult even as to the simple series of transactions, say with respect to the cost under a single cost-plus contract. The accountant may well view with some concern the possibility of giving an opinion subject to cross-examination when the opinion is to be based upon the accountant's professional knowledge of thousands of original entries recorded in dozens of different ways.

The accountant must meet this problem of giving evidence if he is to perform his full duty to his own clientele. The problem of the accountant in this respect is by no means as difficult as the problem of the physician. For half a century the medical journals have carried departments of medical jurisprudence and all the class A-1 medical schools have required courses in that subject. The accountant must study the law of evidence and learn how to prepare himself as a competent witness on values that properly fall within the scope of his own profession.

One is tempted to say something about the lack of skill on the part of attorneys in putting questions to accountants. Many an accountant on the witness stand has failed to give creditable evidence because of the asinine questions put to him by learned counsel. The accountant is not altogether free from blame in this regard. He has not studied the law of evidence as he should study it. The accountant should carefully prepare his evidence with the attorneys to the end that the client may be well served both by intelligent questions asked by counsel and intelligent replies returned thereto by the accountant on the witness stand.

In illustrating the theme here, reference has been made to valuations for inheritance-tax purposes. Those who have followed the discussion thus far will already have in their minds the scope of work on valuations to be introduced in evidence by the professional accountant before the board of tax appeals and, indeed, before each of the government officers and clerks having to do with the administration of income taxation.

Whether the accountant will meet this problem or not is to my mind a fairly serious question. Accountants have not produced any considerable literature on the problems of valuations involved in the administration of the federal capital-stock tax or in the administration of the corporation-franchise-tax laws already existent in many of the states. Some accountants seem to be content to make annual audits and income-tax returns and to leave to bookkeepers and clerks employed within corporations the more intricate professional problems arising out of city, county and state tax reports. Perhaps if the accountant met more squarely the problems of city, county and state tax reports for his clients we would find a greater tendency on the part of banks, trust companies and attorneys to turn to the accountant as the proper person to appraise all current assets and liabilities, whether for inheritance-tax purposes or for income-tax purposes, or even for the purpose of distribution in bankruptcy.

The opportunities of the professional accountant in the preparation of evidence are very great, no matter for what purposes the evidence is finally to be used. The professional accountant, by his education and experience, should be competent in the preparation of evidence and he should undertake to educate his own clients so that they will recognize this competence on the part of their accounting advisor. Year after year as he goes over the closing entries of a corporation client, for example, the professional accountant should view such closing entries from the standpoint of their future use as evidence. This implies that the professional accountant should be engaged, at least annually, in the organization of evidence for future use, and this implication refers to each of the clients whom he serves. Then the accountant can expect to be called upon whenever evidence is required for valuation purposes, whether for inheritance-tax purposes, or for income-tax purposes, or for state-franchise-tax purposes, or for corporate-financing purposes, or for contract settlements, or for any other purpose in which competent evidence is likely to be required. In this respect, the professional accountant may well adopt the rule which Lincoln made the basis for his own life:

"I will work hard, I will study and prepare myself and when my opportunity comes I shall be ready for it."

Passing Examinations

By Charles B. Couchman

When one considers the number of people who annually take examinations for certified public accountant certificates or for membership in the American Institute of Accountants, one is surprised at the high percentage of failures and the question at once arises: What are the causes? Of course, to pass such an examination a thorough knowledge of accounting principles and the methods of applying them is required. But it is presumably true that all those who have passed the requirements necessary to sit for such examinations possess a knowledge of these principles and have put their knowledge to the test in numerous practical applications either to business problems which they have handled in accounting practice or to theoretical problems presented to them in accountancy courses which were supposed to be of a nature somewhat akin to the problems actually faced in examinations—which they often fail to pass.

The accusation is frequently made that these examinations are not a suitable test of qualification to practise as a certified public accountant, and this accusation is based upon the fact that many people pass such examinations who later show that they are not wholly competent, while on the other hand many thoroughly experienced, able and satisfactory accountants have failed to pass examinations.

The question is not a simple one. The fault may lie in the examination; it may lie in the lack of ability on the part of the examinee, or the unsatisfactory results may be traced to conditions under which the examination must be written.

The problem of whether or not such examinations as those set by the American Institute or by state boards which do not use the Institute questions are a proper test of the qualifications of a person who proposes to enter the profession of public accountancy is one which I do not care to discuss at length in this article. Some examinations which have been given are subject to criticism. Many problems have been presented which I feel are not suitable for such a test, but even with these criticizable points the average examination accomplishes its purpose much more successfully than some examinees would have us believe.

A study of the papers turned in as a result of numerous accountancy examinations leads to the following conclusions: First, many applicants for such examinations do not have a knowledge of fundamental accounting principles; second, many who appear to know accounting principles either have little knowledge of how to apply them or do not take advantage of their knowledge; third, many fail properly to interpret the question that is asked or overlook some vital element; fourth, many others, even though they do not err in any of these ways seem to lack sufficient knowledge of business customs and operations; fifth, others, who may have ample knowledge of principles and how to apply them, fail from what is apparently nothing more than nervousness.

Accounting Principles

It seems strange that men would attempt to pass an accounting examination when they were lacking in some of the fundamental principles recognized by the profession, but many evidently do, if one may judge by some of the papers submitted. This article can be of little value to such applicants, except perhaps to deter them from attempting examinations until they have made themselves familiar with at least the basic principles of the subject. While there are many moot points in accountancy and many procedures that have not yet been crystallized into definite and accepted principles, it must not be overlooked that there are certain rules and relations that are accepted in the world of commerce as fundamental.

Knowledge of these fundamentals must be gained by consistent and logical study. This study must be accomplished through some well defined accounting course accompanied by proper instruction from qualified men, or it must be gained by careful reading of authoritative books on the subject, combined with thoughtful consideration of the cause and effect of commercial practices and procedures, always going back of the procedure to discover the reasons and to codify such reasons into a logical scheme of principles.

Application of Principles

In the profession of accountancy a knowledge of principles is of little value if unaccompanied by skill in application. A major purpose in examinations is to offer opportunity to the applicant to demonstrate that skill. It is in this respect that many fail. Failure may be due to a lack in properly presenting the results desired. The setting up of financial statements in proper form is more than merely reaching "an answer." A man who had taken an examination complained of his failure and illustrated his point by reproducing as nearly as he could an answer to a question in which it was necessary to determine the amount of profit and loss resulting from certain stated facts and figures. He had ascertained the correct amount and felt that his grade for that problem should have been perfect. His paper, however, showed no more than a series of additions and subtractions without anything that could be recognized as even an attempt at presenting a profit-and-loss statement according to any accepted or logical form. Application of principles in accountancy involves not only the accurate determination of facts in their proper relation but the presentation of such facts by a method and in a form which will be acceptable to the commercial world.

Interpretation of Problem

Most candidates for accountancy examinations have perhaps a sufficient knowledge of accounting principles and at least a passable skill in their application, but they do not all succeed in the tests, and the reason frequently is the lack of a proper interpretation of the problems presented. Sometimes this fault may be traced back to a lack of clarity in the wording of the problem. Those who devise such examinations frequently fail to make clear the ideas which they have in mind. No doubt the reader has seen at times questions of which no amount of study would determine with any degree of certainty the solution desired or expected by the examiner. Fortunately, however, such ambiguous questions are rare in the best type of examination and are not sufficiently numerous to constitute a legitimate defense for the great number of applicants who fail to grasp the significance of the questions or problems.

Misinterpretation of the questions may result from hurried reading or from failure to appreciate the significance of certain modifying words or qualifying terms. The writer recalls a certain problem given in a state examination which resulted in a heavy list of casualties among the corps of ambitious students who undertook to surmount its difficulties. This result was due to one word which was apparently overlooked by all but a very few. The word was "fiscal" used as an adjective to modify "year". This is a term which should instantly have caught the attention of any accountant, yet the great majority of those aspiring to the title of certified public accountant, as a result of this examination, failed to give any heed to the term and carefully and accurately solved the whole problem upon the calendar-year basis. The history of examinations is replete with such examples but there is neither time nor space to repeat them here. A few more minutes spent in the careful study of a problem, even though it results in a few minutes less for the solution, will usually produce a better net result.

Nervousness

The study of examinations discloses the fact that many applicants have a thorough knowledge of accounting principles and know how to apply them and unquestionably are skilled in the interpretation of problems, yet under actual examination conditions fail to acquit themselves in a creditable manner. The explanation for this can probably be found in the one word "nervousness." It is quite natural and probably inevitable that the accountant attempting to pass an examination is under a mental strain that he would not feel under the conditions of ordinary accounting practice. In the latter, he usually feels master of the situation, whereas he approaches the examination with somewhat of awe and uncertainty.

Some Hints

Let me now suggest to the prospective candidate some definite steps which he can take to minimize such nervousness and help to obviate its evil effects. I suggest five items as worthy of consideration:

Budget the time
Study questions (15 minutes)
Answer easiest first
Relax (5 minutes)
Review (15 minutes)

In accounting examinations, one disconcerting factor is the necessity of working against time, which is in itself always nerve-racking.

For the ordinary two or three-hour examination, take a side sheet of paper and record the number of minutes allowed for the examination. Subtract thirty-five minutes from this. This period of thirty-five minutes is to cover the second, fourth and fifth items above. Apportion the remaining time to the number of questions that must be solved.

Of the thirty-five minutes assign fifteen to studying the questions. Read each question through carefully, checking with pencil any word which has a bearing on the result but later might be overlooked during the actual solving. As each question is read make a symbol at one side of it to indicate to which of three classes it belongs, for instance: one, those which I can answer; two, those that are doubtful; three, those which I can not answer. This gives you a slight clue as to how you are going to come out in the examination. Of course, if all the questions come under the third group, this plan may not be of much aid to you and may not aid at all in decreasing the embarrassing nervousness to which I have referred.

On the other hand, there may be some questions which fall into the first group. If so, an immediate tackling of these will serve to increase your confidence and enable you to work more effectively even upon the doubtful ones.

Answer Easiest First

Make it a rule to answer the easiest questions first. Some applicants think the questions must be answered in the order in which they are listed in the papers and fear that any other order would tend to prejudice the examiners against them. I have not known of any case where this idea was well founded. Examiners are thankful to get correct solutions in whatever order they may be listed. Be sure, however, to give to each question the same number that is assigned to it on the examination papers. If the questions are such that your solutions to each are on separate sheets of paper, they may be readily re-sorted at the close and presented in proper order.

The advantages of answering the easiest questions first are twofold. If you begin on the difficult ones you may never have time for the ones you understand. And the realization that you are correctly solving the questions gives you much greater confidence with regard to the others.

Perhaps more than one courageous soul finding that he had answered all he knew but that more must yet be answered if he was to pass has valiantly and victoriously attacked one of those "fifty-fifty" questions which sometimes appear, in which the query is "Who wins, A or B?" knowing that he had at least an even chance of guessing right.

In the case of an ambiguous question, where even the most careful consideration fails to determine which of two methods of solution is intended, the applicant frequently is nonplussed and passes the question by. In such a question try if possible to determine which of the two methods is more likely to have been in the mind of the examiner; or, failing in that, select the method most common in business practice, and solve according to this method. Be sure to call attention to the fact that the problem is susceptible to two interpretations. Show why you have chosen the one for the basis of your solution. Outline briefly the other method.

Relax

Stop work at the minute your watch shows that only twenty minutes remain of your examination period even though you have not completed the question on which you are working. Slump back in your chair, close your eyes and for a few minutes forget all about the examination or anything of a kindred nature. This period is akin to that in which the swimmer lifts his face for an instant and drinks in a fresh gulp of air. The brain has a chance to relax from its strain. If you have never tried this before, you will be astonished at the freshness with which you can pick up your papers and go on reviewing them.

Review

I do not know whether any analyst has explained it fully, but nevertheless it is unquestionably true that many people writing at high speed make statements on their papers that they never intended to make—important words are omitted, the intended meaning of words is sometimes completely reversed—all because of the haste with which the work is done. Therefore, the most important fifteen minutes of the whole time assigned to the examination is probably that period during which the finished work is carefully reviewed before it is presented. In this review period you may discover some of those unconscious errors such as the omission of important words which you have made in your written work. When you have completed this there may be enough time left for you to go on with uncompleted questions and, perhaps, bring them to a happy solution.

Audit of an Automobile Manufacturing Company

By Charles R. Whitworth

Inasmuch as transportation is one of the principal factors of economic life, and because of the tremendous development of automotive power within the past century, by which the automobile has become one of the chief means of conveyance, it is not surprising that the automobile industry has now advanced to the stage where it is considered a major industry—at least on this continent.

This paper will assume that the operations of the company herein discussed are of such character that the plants are totally utilized in the manufacture and assembling of practically all of the component parts of the completed vehicle, and not mainly in the assembling of units which have been manufactured by other factories.

It should also be borne in mind that these remarks are not intended to constitute an audit programme, but will narrate only some of the special features of the audit which are in a measure extraordinary. Furthermore, these comments contemplate a general verification of the assets and liabilities and of the results from operations (commonly known as a balance-sheet audit) and will not comprise any discussion of checking of the details of transactions.

Before proceeding further it may be of interest to note that the accounting for an automobile manufacturer is sometimes divided into three systems—head office, factory and branch houses. The head-office books, of course, control all the operations and bookkeeping transactions of the factories and the branches separately, and the monthly reports and trial balances prepared at these places are sent to headquarters periodically.

With these thoughts in mind some of the more important items contained in a balance-sheet will be explained.

Sight Drafts and Accounts Receivable

The wholesale distribution of automobiles is conducted through dealers and agents, while the retail customers of the manufacturing company are handled exclusively by the company's branches —the dealer being a customer on an entirely different scale. The dealer's terms are settled on a cash basis, by sight draft drawn on the dealer immediately after cars are shipped from the factory. It is necessary to see that these drafts are paid on presentation, particularly those outstanding at the close of the fiscal period. In days gone by, there was a tendency to force the dealer to accept shipments for which he had already contracted at times when he was not in a position to pay cash, with the result that the sight drafts were not taken up at the proper time. It is, therefore, important to see that these drafts are paid promptly, and in cases where they are not, the items should be followed up for the purpose of ascertaining whether or not the cars were returned to the manufacturer. In such cases the cars should then be valued as unsold at the end of the fiscal year (i. e., at cost or market value). In any event, it is necessary to discover whether drafts are merely out for collection or whether they have already been discounted with the bank, and in the latter event the contingent liability thereon must be noted in the balance-sheet. The aggregate amount of such liabilities will, of course, be ascertained by direct communication with the company's bankers.

Inasmuch as these drafts will ordinarily be converted into cash in a shorter space of time than the average of accounts receivable, it is appropriate that they be separately set out in the grouping of the balance-sheet.

The other items under the caption of cash and accounts receivable do not call for any special comment that is not pertinent to every audit or investigation. It should be mentioned, however, that there is a custom of including in the accounts receivable the memorandum value of equipment consigned to manufacturers of castings or parts. Such transactions should be properly reflected in the balance-sheet and it should be remembered that these accounts are not expected to be realized in cash, but that they are value of property for which the consignee is responsible.

Inventories

As in every other business, the inventory is one of the most important items in the balance-sheet of an automobile manufacturing company, and therefore the question of inventory requires a very thorough examination, particularly in view of the vast amount of working capital required. It is interesting to note, however, that the turnover for this industry is much quicker than in many others.

The auditor will, of course, address his attentions to the verifications of quantities, prices and extensions. It is impracticable, on account of the great volume of the inventory, to do more than make a test of the quantities contained therein because of the expense entailed in this procedure. Moreover it is doubtful whether any firm of accountants would have a staff sufficient to corral and check, coincidentally with the taking of the physical inventory by the company's employees, all of the items contained in the inventory. The car record, which contains consecutive entries of the motor number, serial number, type of model, date entered on production schedule, and final inspection, as well as the disposition by reference to sales-invoice number and other memoranda of shipment, is invaluable to the auditor since it is the means of accounting for production, sales and inventory of finished cars on hand. It should be noted that the cars have been completed and inspected within a reasonable time after they are placed in production. Cars are generally finished within forty-eight hours of the commencement of the final assembly, and therefore the date on work orders of all cars in process should be inspected for the purpose of ascertaining the reason for any delay in the completion of the work. It might possibly develop that some cars were erroneously inventoried as finished, whereas further work might have been required before the cars were shipped. A comparison of the cars included in the inventory with the final inspection ticket is therefore desirable.

The inventory is classified as follows: raw material and supplies, work in process, finished parts, finished cars, and any convenient subdivisions of these captions.

The generally accepted basis of cost or market, whichever is lower, should be adopted for inventory purposes, and verification of the prices based on this principle does not present any great difficulties if the manufacturer employs an adequate accounting system. The valuation of raw materials is readily susceptible to verification by reference to stock records and current invoices on file. The work in process will include labor, material and a certain percentage for factory overhead. The values of labor and material included in work in process are based upon so-called specification costs, which are revised periodically to conform with the latest time studies and material costs.

Specifications will include part and other unit costs which require to be identified with the latest current cost on each particular item contained therein.

The specification costs are compiled in major assemblies and sub-assemblies of the component parts and the total cost of the finished car is summarized by assemblies. Cars in production are treated as work in process until the final inspection is completed. It is necessary to analyze the car-production account in order to see that the material and labor accounts are properly relieved by the specification cost of finished cars, and that the latter account is likewise credited with the cost of cars shipped, and, furthermore, to determine the relation which this cost bears to the values contained in the inventory.

The distribution of overhead is a problem which requires careful investigation. Another factor to bear in mind is that the rate of burden should not unduly raise the value of the items which are included in work in process. In the early days of the automobile industry, the fiscal year could be divided into two distinct seasons, manufacturing and selling; but now the industry has advanced at such a rate that the manufacturing and selling run hand in hand throughout the entire year. It is generally necessary for the factories to close down in order to take a physical inventory (at least once a year and possibly more frequently) and sometimes when the preparations for development of new models are extensive. A factory might also have to close on account of depression in business, or because the rate of production had been developed considerably in advance of the actual demands by the consumer, although such a state of affairs has not been common recently. These shut-downs naturally affect the rate of overhead, because they must inevitably curtail the original production schedule in a marked degree. The problem then is to determine a fair rate of overhead for valuation purposes in order that the inventories may not be over-valued. After all, if the principle of cost or market, whichever is lower, is applied consistently, it matters little if the burden at the end of the fiscal year be in excess of the so-called normal rate, provided that the inventory price leave a sufficient margin for the cost of completion of the goods, together with an allowance for distribution, selling and general expenses and a regular margin of profit. These remarks also apply to the value of finished cars. Furthermore, these inventory values should be compared with the actual net selling price, less an allowance for other expenses and profit.

The position of finished and service parts also requires special consideration. While the manufacture of a specified model may have ceased, such cars may still be in use by the consumer, the length of service in some instances being far beyond the average life. It is, therefore, incumbent upon the automobile manufacturer to maintain a supply of past-model service parts to fill the needs of his customers so long as there is a demand. Quite frequently it is necessary to manufacture another supply of service parts for old models. It will readily be perceived that the stock of parts on hand requires careful watching to ensure that the accumulation of old parts is not replete, as after production of a model has ceased the demand for parts pertaining to that model will lessen in greater proportion each succeeding year. The supply on hand of service parts should therefore be governed by the probable requirements of the future, with due regard to the length of time since the cessation of manufacture of the respective models. Any decision as to the existence of an over-stock may be reached only after a full survey of the inventory and sales, and it is a matter requiring judgment and experience.

Service parts at the factory are usually valued at cost, and a reserve sufficient to reduce the value of the obsolete and overstocked parts to scrap, or realizable value, should be provided if necessary.

The inventories at the branches are usually valued at the price at which they are invoiced by the head office. A reserve sufficient to reduce this price to the basis of cost or market, whichever is lower, is generally set up on the books at the head office. The value of used or second-hand cars is one which should be closely watched, as the market value is at all times uncertain, depending entirely on current conditions. The valuation of used cars should always be on the conservative side.

The balancing of inventories is of vital importance, and the auditor should satisfy himself that the inventory of raw material is not in excess of the requirements for current schedule of production.

Another feature important to an automobile manufacturing company is development and experimental expenditures, which must be considered in one sense as an exigency although at certain times they may reach unusual proportions, especially during the creation of new models. It is inevitable that any large industry must expend vast sums annually in research and experimental work, and where the expenditures are current the correct method from an accounting standpoint is undoubtedly to charge such expenditures to current operations. This rule, however, may be modified when extensive changes are effected in the already existing models by the adoption of entirely new lines, such as occurred recently with practically all automobile manufacturing concerns. These changes require an extraordinary expenditure in the way of special tools, dies, jigs, and labor, and it is generally impracticable to absorb these costs in the initial stages of new production. It is, therefore, only fair that the excess over what may be considered normal expenditures should be deferred beyond the current year. The length of time over which these expenditures should be carried is a matter of judgment and differs according to conditions. In any event, they should be written off as soon as possible, and must be absorbed before another complete change of models is adopted.

Among these expenditures, there is generally a perpetual outgo for experimental cars. Such expenditures which have a useful value in the future development of the company's lines or models should be considered as prepaid production costs and carried as part of the inventory in the balance-sheet. If, however, it has been determined that the experiment is nonproductive, such expenditures must be charged off immediately to current expenses.

Capital Assets

The growth of business entails a continuous expenditure of large sums of money for capital investments representing additions to real estate, plant, machinery and equipment, and in leaseholds and improvements. Even with established concerns the expansion of business constantly requires further investments in the already existing plants, either by way of additional facilities, or perhaps replacement of some older buildings by more modern and extensive structures. The scrutiny of these expenditures is of great importance, and it does not differ from the examination required in any other line of business.

The character of the capital expenditures of an automobile manufacturing company is much the same as that of any other large manufacturing company. The investment will include some machines and machine tools, jigs, and dies which are peculiar to the industry and to the particular series of models which are in course of manufacture. All these special tools and dies will be amortized over a short period of time and in any event must be charged off when they are obsolete.

Small tools are usually carried under the caption of stores or supplies and are included as part of the inventory until they are requisitioned for use in the factory. The practice is to charge them to expenses immediately when they are so requisitioned, and it is impracticable to make an inventory of them because they are scattered in divers places in the factory. Furthermore, because of their perishable nature and of rough usage the actual length of time in which they are in use is extremely short. It is assumed that the initial investment required completely to equip the factory with the necessary tools or the cost of replacement thereof will be carried always in the investment account.

Great care should be taken to see that so far as possible all items dismantled are properly revealed in the accounts.

The rates of depreciation used by automobile concerns vary according to the use to which the machinery and equipment is subjected. To determine the adequacy of the depreciation rates, it may be necessary to enquire into the disposition of the replacements—in some instances they are properly charged against the reserve, while in others they are written off to current operations. In the latter case, the company is in effect setting aside additional depreciation.

The amortization of leaseholds does not require any particular comment.

Current Liabilities

Verification of accounts payable and other outstanding liabilities requires the same careful attention in automobile manufacturing as in any other business, and it is important that merchandise in transit at the end of the fiscal year should be taken into consideration because of its effect on the ratio of current assets to current liabilities. It will readily be understood that as automobile manufacturing companies buy in very large quantities the value of merchandise in transit is a considerable item at any time. It is possible that there may be a custom not to include in accounts payable merchandise which has been purchased at buyers' (or sellers') risk and is in transit at the close of the fiscal year but has not yet arrived at the plant before the close of the fiscal year. It is also possible that large quantities of purchases have arrived at the plant during the inventory period which have not been taken into accounts payable or in the inventory, or perhaps have been inventoried without taking into account the liability therefor. All these conditions require careful investigation and adjustment. It is also essential that all other liabilities, particularly patent infringements, damage suits and workmen's compensation claims, should be taken into account.

Dealers' Deposits and Reserve for Additional Discounts and Allowances

It is a general custom for the automobile manufacturer to demand that the dealer deposit a guarantee for performance of his contract. These contracts set forth the minimum number of cars which the dealer agrees to take during the fiscal year and outline the graduated scale of discounts showing the minimum and maximum rate to be allowed to the dealer under specified quotas. Occasionally there may also be an allowance on account of price reductions which are retroactive. The amounts due the dealers under these arrangements must be provided for in the accounts at the end of the fiscal year.

Profit-sharing Plans

Some of the larger automobile concerns have stimulated the efforts of their employees by profit-sharing contracts, which require the setting aside of a certain proportion of the annual profits to be distributed among the officers and employees. The amount to be provided can, generally speaking, be readily ascertained although there may be some complication if the contracts stipulate that the federal income taxes shall be taken into account as an expense before ascertaining the net profits available for the officers and employees, since these bonuses are properly deductible as an expense in the income-tax return.

Contingent Liabilities

The contingent liabilities by which the automobile manufacturer may be affected are substantially the following:

1. Notes, trade acceptances and drafts discounted,
2. Guarantee of principal and interest of loans to other companies,
3. Guarantees of dealers' notes discounted with bankers and automobile finance companies,

4. Guarantees on contracts to make good the defects on work done or goods supplied,
5. On contracts for purchases or sales for future delivery.

Regarding the first item, it is necessary to show on the face of the balance-sheet the par value of the notes discounted, for on the one hand the company will have to pay the bankers in full if these notes are not met at maturity, while on the other hand it is possible that they may not recover any or all of the par value of the notes.

The financing of the sales of automobile concerns has assumed such proportions that the matter is of paramount importance to manufacturers, bankers and general public. It has been stated by economists that as many as 75 per cent. of the cars retailed are sold by the so-called instalment plan. The reader will readily understand that the structure of the finance company must be substantial in order to carry the load required under these conditions.

The financing is divided into two classes, wholesale and retail; the wholesale being carried on between manufacturer, finance company and dealer, and the retail between the dealer, finance company and the consumer. In some instances, the manufacturer may conduct both the wholesale and the retail business.

The credit terms usually require that a certain proportion of the sales price be paid in cash and the balance is settled by notes which mature at specified intervals. The notes are in turn discounted with a finance company.

The time allowed for payment to the manufacturer by the dealer covers a much shorter period than the time required by the consumer. In the first instance the acceptances cover a period of about three months, while the customers' notes may run over a period of eighteen months.

It is generally incumbent on the manufacturer and the dealer, in the case of wholesale and retail business, respectively, to repurchase the cars in the event that full payment of the notes is not made to the finance company. It is not uncommon, however, for the finance company to repossess the car and to find a new purchaser for it. Cars sold by retailers may be subject to chattel mortgage or to a conditional sales contract. In the latter event the purchaser does not become the owner of the car until the last instalment has been paid. The dealer may thus be liable as endorser of the notes, unless the endorsement is without recourse, or by his agreement to repurchase the car where the finance company has failed to collect all the unpaid instalments. In this event, the dealer is generally liable only to the extent of the unpaid instalments plus stipulated collection charges. The manufacturer's liability in these conditions generally arises through the discounting of the dealers' notes on the wholesale plan. It may be necessary for him to guarantee his dealers' paper on the retail plan. It is also possible that it may be necessary to discount the notes taken by the retail branches of the selling corporation of the automobile manufacturer, and in such cases the automobile concern has two classes of liability.

The extent of the liabilities under such arrangements can not be definitely stated at any time. From past experience, however, it is usually possible to measure the probable amount of losses arising therefrom, although unforeseen circumstances may be a cause of creating a much greater liability than would be normally expected. It is the writer's belief, however, that so long as a reserve sufficient to take care of these losses is provided on the books, it is unnecessary to make any other reference to these contingent liabilities in the balance-sheet, unless by endorsement of guarantee there is a further direct obligation on the part of the manufacturer.

The remaining items included under contingent liabilities can be provided for in like manner. In passing, however, it should be mentioned that whether or not the manufacturer guarantees his products directly in writing or through his agents, there is always the moral obligation to make good any defective workmanship in manufacture. The demands of a customer in this respect are generally met immediately, so long as the complaint is justified or perhaps merely on the basis of good policy. It is possible, of course, that a defect might be so extensive in the company's output that it would be necessary to provide a reserve at the end of the year in order to relieve the future years' operations of an expense which belongs to the year in which the product was manufactured.

In conclusion, the writer believes that he has dealt with the more important matters contained in the balance-sheet of an automobile manufacturing company. It is hoped that these remarks may be of interest to the general reader and that from them the student may derive some benefit.

Interpretation of Financial Statements *

By John R. Wildman

Financial statements, as instruments of service to business, have probably attained a place of more importance in the United States than in any other nation in the world. In no country is a greater effort being put forth in an endeavor to interpret and utilize financial information in the conduct of business affairs. The fields served by financial statements include credit, investment, administration and management, government, engineering, law and accountancy. Such information is used also in relation to contracts of operation, business transfers, fiduciary integrity, bankruptcy and receivership and business reorganization.

The problem of interpretation is to determine significance. The problem of interpreting financial statements is concerned with determining first: What are the representations made by means of the statements? second: If the representations are true, what is their significance?

An unqualified item of merchandise inventory appearing among the current assets in a balance-sheet is a representation which custom fairly well has established that the goods are sound and salable, and that they have been valued at the lower of cost or market. The significance is that the amount invested in such goods may be expected, within a period of time consistent with the credit terms, money conditions and average efficiency in making collections, to pass with the addition of profit through the form of accounts receivable into cash which will be available for the liquidation of current liabilities.

The significance of a merchandise inventory may be obscured if some other item in the balance-sheet affecting the inventory is not shown in relation thereto or clearly described in order that it may be so related by an interpreter of the balance-sheet. An interesting case which arose recently presented a situation in which a company was obligated under contract to make certain future deliveries at a loss. Materials which had been bought on a rising market had to be used to manufacture the goods for delivery under the contract, with no possibility of procuring other materials to substitute at a lower price. It was known that the loss would

* An address delivered January 18, 1926, before the New York Association of Credit Men.

amount to a large sum and that it would fall on certain materials in the inventory which were carried at the lower of cost or market.

In the practical controversy which ensued over the representations in the balance-sheet, three different positions were taken by different parties as to a reserve which had been created through a charge against surplus for the purpose of anticipating the loss. One party contended that it was a current liability. The second party held that it was a general reserve, on the ground that surplus had been charged and that as long as creditors were thereby protected against the paying out of cash as dividends while they waited for settlement of their accounts every necessary purpose had been served. The third party insisted that the reserve should be deducted from the inventory item, inasmuch as there would be less in the way of value with which to satisfy creditors than appeared in the current-asset group.

The last view appears to be the correct one. The reader of the balance-sheet is entitled to understand from the inclusion of a merchandise inventory item in the current-asset section that when the inventory shall have been converted into cash it will be at a greater rather than a lesser value. While such goods as inventory should contain no element of profit, after having been turned over the cash resulting will carry an item of profit. Thus he concludes that more rather than less will be available to satisfy current creditors.

There are various ways of developing significances. Consider the much-neglected income statement. Instead of the conventional additions and subtractions of figures leading to a result which merely ties the surplus into the balance-sheet, you may see therein some of the reflections of operating and general and financial management. Particularly, if you will reduce the figures to a dollar basis, you may see how the dollar receivable from customers has been divided among the parties who contributed to the cost of the goods or services supplied to such customers. If your imagination will permit: First, there is the supplier who furnished the materials; next, there are workmen who fashioned the goods; then, the salesmen who sold them; clerks who kept the records; managers who administered the enterprise; parties who lent their money; those who furnished property or service facilities; the government which exacted a tax; capital invested in property which wore out and had to be replaced; other capital losses, and, last, the profit which went to the proprietor—fanciful, no doubt, but interesting and perhaps a concept which some day will be developed and elucidated so as to be extremely useful as a means of interpretation.

Significances such as our minds are capable of grasping at the present time are suggested principally by comparisons of various kinds. One may compare current figures with similar figures of prior periods; or figures of one enterprise with like figures of a similar enterprise; or specific figures with various standards. Thus may be indicated the trends of various activities and the efficiency of those responsible for the direction of them. The cost of the goods may be getting out of proportion to the profit. Selling expenses may be too high. The margin of operating profit may not be sufficient to sustain the load of property expense. The net-profit factor indicating the percentages taken out of the enterprise may show that some of the profit should have been left in to be devoted to strengthening the organization and assuring its future. In one instance statistics of this character drew sharply into the foreground an expense for borrowed money which was excessive. Investigation disclosed the fact that working capital was being obtained through hypothecation of accounts receivable at interest rates of 24 per cent per annum.

Returning to the balance-sheet, perhaps one of the most difficult items thereon to interpret is the one frequently designated as surplus. The significance of surplus, in the absence of qualification, is that it is an accumulation of profits resulting from operations and in the discretion of directors may be declared away as dividends. The consideration of surplus raises a number of interesting questions. One of these questions is: May anything other than profits arising from operations be considered surplus which is subject to the declaration of dividends? In other words, may a corporation write up its property values on the basis of an appraisal or on the judgment of directors as to values and credit an amount equal to the increase in value to the surplus account, subsequently declaring a dividend out of such surplus? If this is permissible, may not the same reasoning and formula be applied to capital stocks of other corporations carried as investments? In the case of a wholly owned subsidiary with a surplus of its own, what is to prevent the holding company from revaluing its investment on the basis of the book value of the subsidiary and crediting the increase in value to surplus? Again, in a case where preferred shares of other corporations are carried as investments at a cost which is less than par, why may not the holding company carrying this investment write their value up to par and take into surplus the amount of the increase in value?

The leading case on this question is *Williams* v. *Western Union Telegraph Company*, 93 N. Y. 162. In this case the court defined surplus as the excess of assets over liabilities and capital. After this definition, the decision continues: "Such surplus belongs to the corporation and is a portion of its property, and in a general sense may be regarded as a portion of its capital, but in a strictly legal sense it is not a portion of its capital and is always regarded as surplus profits."

Without devoting too much time to this question it appears that from a legal point of view any excess of assets over liabilities and capital may be regarded as surplus profits. This concept, however, is attended by certain dangers from the point of view of business policy, in that there is considerable question as to the soundness of declaring dividends payable in cash out of surplus represented by unrealized profits. Obviously, it must be admitted that such course would be legal and that a way might be found to obtain the cash with which to make the payment of dividends. In view, however, of the accounting differentiation between surplus derived from profit on operations and that arising from valuation of assets, any surplus item appearing on a balance-sheet is subject to investigation. From a credit point of view, this matter is important, since it is related to the appropriations for dividend purposes of cash which more properly should be applied to the liquidation of current liabilities.

A second point for consideration in relation to surplus is the effect of various state laws permitting the issuance of shares without par value. In some states, apparently, there is serious conflict between the law on one hand and economic principles, good accounting and rational business administration on the other. The Maryland laws governing corporations, for example, permit the issuance of both preferred and common shares without par value, for such consideration as may be fixed by the board of directors or by the charter of the corporation. The state of Delaware, likewise, permits corporations to issue shares of capital stock, both common and preferred, without nominal or par value, for such consideration as may be fixed from time to time by the board of directors. Thus, it becomes possible for a corporation to issue its shares, receive large sums of cash in exchange therefor, credit some nominal amount per share to capital and place the remainder in the surplus account. There may be no question that this procedure is legal when properly authorized by action of the directors, and in all probability surplus so derived might be appropriated later for dividends. There is grave doubt that any reputable and well meaning corporation consciously would subscribe to the policy of paying dividends out of capital, yet the way seems to be open by the laws in some states, and if surplus so derived is not segregated, directors may unwittingly declare dividends therefrom.

The point at issue is that any attempt to interpret a balance-sheet must give serious consideration to the item of surplus. The casual reviewer is not justified as he should be in assuming that surplus unqualified by further description has been earned and may be appropriated for dividends, if sufficient in amount, without detriment to the creditors. Good accounting practice has adopted the policy of earmarking surplus derived in ways other than from earnings, in order that there may be a clear understanding as to the surplus available for dividends. These segregated items have been described in various ways by different accountants as capital surplus, as surplus arising from valuation of assets, or as surplus representing the excess of capital received for shares of stock in excess of the stated value thereof. While perhaps inconsistent with the principles of accounting, nevertheless a surplus item not otherwise described is open to challenge as to its origin. In a somewhat recent offering, common shares were shown on the balance-sheet at a nominal value of ten cents each, while the remainder of the proceeds of sale was merged with other surplus from earnings and revaluations and constituted about fifty per cent of the total surplus item. Only a person with knowledge of facts beyond those disclosed by the balance-sheet could have determined the relative amount of capital surplus involved.

Analysis of items which appear in financial statements is another means of bringing out significances. Analysis sometimes discloses strange bed-fellows. In the balance-sheet of an average-sized industrial company, marketable securities were shown as a current asset. The line of cleavage between current and fixed assets in the matter of investments long since has been established.

According to the generally accepted practice, securities held for control, financial, operating, or trade advantages—securities which can not be disposed of without detriment to the holding company—are classified as fixed assets. Securities which may be disposed of at will and converted with readiness into cash are permitted by accountants usually to be included in the current-asset group. Consequently, no objection apparently may be raised to the inclusion of marketable securities in the grouping for current position if the securities are as represented. One even might overlook a small amount of treasury stock in certain circumstances if the amount involved were negligible as compared with the total of marketable securities. But when a corporation includes in such caption a young railroad, the book value of which is equal to half the amount represented to be marketable securities, it seems that one reasonably might demur at such inclusion. The justification advanced in the case referred to was that the railroad was not necessary to the operations of the industrial concern; that it could be sold at any time; and that as a matter of fact the owning corporation then was entertaining an offer of purchase. Imagination in business is well recognized as a valuable asset. It is wonderful to behold sometimes the point to which imagination may be stretched in order to gain a favorable current or other position.

Consolidation of financial statements sometimes brings out odd relationships which have a bearing on significance. What may appear to be a favorable condition of one corporation, when judged on its own statement, often suffers when brought into consolidation with the condition of other companies to which it is related. One company which in itself is fairly prosperous may be having its life blood sucked away by some unwisely conceived or badly operated subsidiary or other poor relation. Business men who are thoroughly familiar with one line sometimes become interested in fads and fancies in other fields, and risk their success by dabbling in industries where they are not qualified to operate. For this or whatever other reason there may have been, a certain prosperous concern went into a related line and organized a subsidiary company in which it acquired all the capital stock. The venture had a hard struggle and was a constant drain on the parent company. As a means of meeting current financial needs, the subsidiary issued trade acceptances to the parent company, charging the inter-company account thereof. The parent company, which had good financial contacts with several banks, discounted the acceptances. The proceeds were advanced to the subsidiary and credited by the latter to the inter-company account. Thus, the subsidiary had received cash and issued acceptances payable. On the face of the parent company's balance-sheet appeared no trace of the transaction which involved a large sum, further than a footnote which mentioned a contingent liability for trade acceptances discounted. Only when the balance-sheets were consolidated was the true significance of the trade-acceptance situation revealed. What might have appeared on the parent company's balance-sheet to be a contingent liability on account of general trade relations was as a practical matter a direct liability to the banks.

Independent consideration of one unit in a group of enterprises is unsafe without consideration of related companies. Kiting of one kind or another often is concealed through inter-company accounts. Receivables of one company which may go to make up a favorable current position are payables of another company in the group. Securities, likewise, may contribute to a satisfactory financial condition, when in fact some of the securities may be those of underlying companies with deficits. In a case which is the subject of current gossip, one company, with a substantial deficit, is said to have reorganized its corporate structure and leased its plant and operating facilities to the former parent company under a contract calling for large annual rentals, in order that the parent company might be relieved of an unfavorable showing which would result from consolidation. The federal reserve board, something over a year ago, promulgated a regulation which requires that whenever the borrower is closely affiliated, or controls subsidiary corporations or firms, the borrower's statements shall be accompanied by separate financial statements of such affiliated or subsidiary corporations or firms. This is only a part of the regulation, but the remainder thereof does not apply to the point in question. The point is that interpretation of a balance-sheet representing one of the parties in a group is hazardous and likely to prove unsatisfactory unless the statements of the other parties are subjected to consideration at the same time.

Comparisons, while affording another means of interpretation, have their limitations. Usually, they suggest further investigation in order to ascertain the facts rather than establish significances which are conclusive immediately. The increase in cost during one period over that of a preceding period requires liberal investigation before one may reach a final conclusion as to the cause. Manufacturing costs, involving as they do three distinct factors which are subject to many variations, illustrate one of the serious complications involved in attempted interpretation. The item of materials alone offers plenty of opportunity for consideration. Increased cost of materials may be accounted for by an increase in the purchase price, by a change in the basis of relieving stores or the method of pricing materials charged to the cost of consumption, by an increase in the waste factor, or by adjustments incident to inventory valuation, etc. The same application might be followed through with respect to labor and overhead. Consequently, any possibility of arriving at final conclusions as a result of comparisons appears to be somewhat hopeless, unless the investigation is pursued far enough to establish the facts which are back of the figures. Comparisons, however, do show trends and indicate tendencies which may have a very important bearing on the question of administration in which credit grantors are interested.

Perhaps it is because of the obvious difficulty, in the light of our present state of knowledge, of attempting to utilize comparisons for the purpose of drawing final conclusions that so much attention has been given to the subject of ratios. Ratios are a means of indicating relationships, and relationships frequently are valuable in the work of interpretation. Ratios, however, like other means of interpretation, should be used with discretion. Some of the ratios advocated are sound and dependable. Others are unsound and misleading. The ratios which show the various gradations of profit in relation to sales are dependable and helpful. There is between sales and accounts receivable a relationship full of significance for credit men. There is also between finished-goods inventories and sales a relationship which is of interest to both manufacturing and selling departments. It still remains, after several years' use of a ratio involving the two factors, for someone to demonstrate a relationship between accounts receivable and inventories. There is, however, an opportunity for someone to develop the relationship existing between finished goods and sales in the utilization of working capital, taking into consideration the turnover thereof. One ratio frequently misused is that which results from the division of owned capital by borrowed capital, instead of setting up two ratios: one to show the relationship between borrowed capital and total capital, the other the relationship between owned capital and total capital. But withal ratios have served a very useful purpose in stimulating thought along the lines of interpretation.

Consideration of the subject of interpretation would not be quite complete, it seems, without some reference to financial statements which appear in the reports of certified public accountants, and perhaps to the reports themselves.

A certified general audit report with an unqualified certificate is a representation that the accounts as stated are correct, having been verified by an independent and unbiased reviewer. While the representations may be accepted as a basis for reliance, they may not be regarded as having been guaranteed by the accountant. An accountant is required to be qualified by education and experience for the work which he undertakes, to exercise his best skill and use reasonable care and diligence in the execution of his work. Being human, he is fallible and may not be held for errors of judgment if he can show application of reasonable skill and judgment.

Accountancy practice, being in a formative stage in this country, has made relatively little progress in the matter of standardization. Little has been done to acquaint the general public with the scope and classification of accountancy service. While some individuals who are familiar with the subject realize that a certified public accountant's work is varied, few persons understand that there are many different types of service and that these types must be differentiated. Some of the work which a certified public accountant does may be classified as follows: general audits, balance-sheet audits, cash audits, partial audits, general examinations, limited examinations and investigations. An accountant also prepares and reviews tax returns, contests assessments and prosecutes tax claims, prepares and renders opinions on tax matters, conducts surveys and devises and installs systems in relation to the general accounts, to the work of cost finding and to budgeting. Miscellaneous service embraces preparing and rendering opinions having to do with accounting, financial and business matters, giving testimony in court, acting as arbitrator in accounting controversies, rendering advice in accounting matters, preparing statements from books or records without verification, and so on through a long list.

The variety of service gives rise to a variety of reports. While it is incumbent upon an accountant to set forth clearly in his reports the scope and character of such work, and his conclusions after its completion, it is equally incumbent upon those who use his reports that they read the reports and give consideration to the accountant's representations. Instances are known where financial statements in accountants' reports have been used without the reader having read the accompanying comments which altered entirely the significance of the statement. It seems fair to point out to those who have occasion to consider reports of certified public accountants that some contain certificates while others do not; that some certificates are unqualified while others are qualified for the purpose of excepting certain items which the accountant has not been permitted or able to verify to his satisfaction.

Reports on general audits, balance-sheet audits and general examinations usually should be accompanied by certificates, but the certificates must be read and considered before the report may be accepted as a basis for reliance. The report on a limited examination usually will not contain a certificate, or if it does the certificate will be so highly qualified as to nullify any value which the report may have.

Limited examinations as a type are the bane of an accountant's existence. Taking the position that he may not refuse to serve anyone who seeks his services legitimately, the accountant sometimes undertakes to make a limited examination in which the work is confined to a verification of certain items only or only a partial verification of some of these items. The restrictions are placed upon the accountant by the client, the client's motive usually being to keep down the expense. Cases have been known where reports on limited examinations have been issued for home consumption, as it were, only to be used later in seeking bank or commercial credit or in supporting credits already established.

Certified public accountants need the coöperation of credit men in eliminating engagements which call for service of this type. An experience or two of having such reports rejected as being of no value for credit purposes will help to educate clients to the necessity of procuring for credit purposes general audit reports with unqualified certificates under engagements in which the accountant is permitted to satisfy himself reasonably as to the accuracy of the financial results as well as transactions leading to such results.

Finally, it seems that we are forced to the conclusion that the art of interpretation is in its infancy. Relatively little is known concerning it. The subject is full of possibilities. As it is further developed, it will prove increasingly useful in the matter of credit, investment, management and administration and to the various other purposes which financial statements serve.

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EDITORIAL

Illinois Law Declared Unconstitutional

The supreme court of Illinois on February 18th declared unconstitutional the accountancy law enacted by the legislature of that state in 1925. This action, of which notice is received as we go to press, automatically restores the law of 1903. When the act of 1925 was passed over the protest of accountants and when the governor of Illinois had permitted it to become law in spite of the objections of leaders of the profession, there was a feeling of consternation in the minds of all who have the welfare of accountancy at heart. The Illinois Society of Certified Public Accountants immediately set in motion litigation to test the constitutionality of the law and the success which has now been achieved reflects great credit upon the members of the American Institute of Accountants who constituted the special committee charged with the duty of obtaining relief by the courts from the anomalous conditions created by the legislative and executive branches of the state government. Hearty congratulations to Arthur E. Andersen, F. B. Andrews, W. M. LeClear, George W. Rossetter and C. R. Whitworth, and congratulations also to those other members of the Institute whose pecuniary assistance made possible the conduct of the suit.

The decision is reported to have sustained all the contentions of the Institute and to have gone so far as to say that under the present constitution of Illinois no law preventing citizens from practising as public accountants is enforceable. Time does not permit extended notice of this important decision, but it is hoped that the full opinion of the court will be available for publication in the bulletin of the Institute to be published March 15th.

Opportunities for College Graduates

The American Institute of Accountants has for some time been giving consideration to the possibility of encouraging students in the leading colleges of the country to undertake accounting as a vocation. Various suggestions have been brought forward, but until now it has not seemed expedient to undertake any definite campaign to bring accountancy to the notice of college students. It was felt that anything resembling an ordinary employment agency would be awkward to handle, and there was no assurance whatever that the right men would be attracted and if attracted that they would find employment with firms which would offer them continuing occupation. Now, however, the movement has been started and the Institute has created a committee which will supervise a bureau for placements which it is hoped will act as a clearing house between the accounting firm and the college student. The bulletin of the Institute published February 15th contained a brief description of what the bureau for placements will try to do. A booklet describing the work of accountancy and the opportunities of the profession has been prepared and will be distributed to students in the senior classes of all the principal universities and colleges. The text of this pamphlet will be reproduced in the April issue of this magazine. The bureau for placements will offer its services to all members of the Institute and to students in colleges. No fee will be charged to the prospective employee but employers will be required to pay a fee of $50 for every man engaged. The bureau, of course, must be self-supporting and although a voluntary contribution to the funds has been made by a few members it is felt that experience as time goes on will make it necessary to charge a rather substantial fee. The bureau expects to function quickly, and it is confidently expected that many men will be available after July 1, 1926. The article in the bulletin describing the work of the bureau says:

> "This activity of the Institute is the outgrowth of long discussion and serious consideration. It is a concrete attempt to help in one way to solve the problem with which the profession has been faced for several years, namely, that of building a permanent staff qualified to carry on in a field where the work has increased greatly in volume and become increasingly exacting in its demands upon those who undertake the practice of accountancy."

A Various Nomenclature

An English contemporary quoting *The Financial Times* says:

> "An application was recently made before Mr. Justice Lawrence for the appointment of a receiver who was described as a 'certified accountant.' The judge said that he had heard of a chartered accountant and an incorporated accountant, but he did not know what a 'certified accountant' meant. None of the counsel in court was able to enlighten him."

It is rather confusing to have so many kinds of designations for an accountant. "Certified public accountant" in this country has a definite significance much the same as that which attaches to the words "chartered accountant" or "incorporated accountant" in Great Britain, but so far as our records show there does not seem to be any authority for the use of "certified accountant" outside the United States. Perhaps the applicant for appointment as receiver has been unconsciously influenced by the peaceful penetration of Britain which Americans are conducting. A correspondent who draws attention to this incident expresses the belief that it might be better if accountants throughout the world would simply adhere to the expression "public accountant." He says that we have no chartered dentists nor certified doctors of medicine, nor incorporated doctors of divinity; and he is an advocate of the simple expression "public accountant." Perhaps this argument might have been valid thirty years ago, but today the words "certified", "chartered", "incorporated", etc. have distinct meanings and those who are entitled to the use of them rightly place a high value upon them.

Accountants and the Treasury Department

In the course of hearings before the senate select committee on investigation of the bureau of internal revenue, which were reported in a very limited edition, there was frequent reference to the difficulties which the bureau of internal revenue has to face in regard to the character of practitioners, notably certain accounting firms, whose names for the present purpose are unimportant. In passing it may be remarked that the two firms most frequently mentioned are without any representation whatever in the American Institute of Accountants. The matter has been given such meager publicity that it may be permissible to quote some of the more important comments which were made by members of the committee and by witnesses at the hearings. Those who can obtain copies of the reports, notably those of the sessions of May 21, 25, 26, 27, 28, 29 and 30, 1925, printed as part 18 of the report, may read for themselves, but the publication is difficult to obtain because of the small number issued. L. C. Manson, counsel for the committee, reading from a report prepared by L. H. Parker, chief engineer, quoted as follows:

> "There are, of course, many accounting firms and other experts who maintain a high standard of ethics, but the other class is sufficiently numerous to cause serious trouble.

"The corrective organization for this matter is the committee on enrollment and disbarment. This committee appears to be doing good work, but two suggestions can be made. One suggestion is that delay in trying cases should be reduced to a minimum on account of cases which may go through, handled by accountants whose work is questionable, and thus cost the government money. The second suggestion is that there should be a set-up whereby employees of the bureau can send in charges direct to the committee on enrollment and disbarment instead of solely through the section chiefs and so on up through the line of superior officers, any of whom might suppress the information."

Responsibility Really on the Taxpayer

Then follows a description of the case of one firm with particular reference to a form of partnership agreement which seemed to meet with general disapproval. The Parker report does not go far enough when it says that the only corrective organization for this matter is the committee on enrollment and disbarment. There are other corrective agencies which should be and could be easily employed. In the case in question the American Institute of Accountants would have no jurisdiction, but it should not be a difficult matter for the taxpayer to inform himself as to the general standing and ethical practices of the accountants or other agents whom he employs. The activities of some so-called tax experts are notorious, and if the department would exercise its influence to encourage the engagement of those firms which are above question, the labors of the department itself would be vastly simplified and the interests of the taxpayer would be protected. Unfortunately the committee on enrollment and disbarment has been extremely dilatory in dealing with complaints which have been made to it. Perhaps there is reason for delay, but to the ordinary mind it appears a rather simple matter for the committee to hear and determine the justice or injustice of allegations concerning practitioners. Only a few suspensions and disbarments have been effected and there is at least a suspicion that some of the firms which are still permitted to appear before the bureau should be investigated and the results of investigation should be given effect and publicity. This is what the Parker report, no doubt, has in mind. The committee on enrollment and disbarment is not doing its full duty when it permits delay for any cause whatever in the thorough and impartial investigation and decision of complaints before it. The hearings to which we refer were held nearly a year ago. Probably there were many complaints against other practitioners made before that time, and there may have been many others since, but the list of disbarments and suspensions still remains restricted.

Quotations from the Record

Following the introduction of the Parker report to which we have referred the record contains a discussion from which the following excerpts are taken. (The dramatis personæ are Senator James Couzens, chairman; C. R. Nash, assistant to the commissioner of internal revenue; A. W. Gregg, solicitor, bureau of internal revenue; L. C. Manson, counsel for the committee; Senator William H. King, member of committee; McKenzie Moss, assistant secretary of the treasury.)

THE CHAIRMAN: Who controls this committee on enrollment and disbarment?

MR. NASH: The committee on enrollment and disbarment is a committee appointed by the secretary, which passes on all applicants who desire to practise before the treasury department. The bureau of internal revenue is represented on that committee, but does not control it and has no jurisdiction over it.

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THE CHAIRMAN: I do not understand that it is the province of this committee to go into that work of the committee on enrollment and disbarment, because that is not a part of the bureau of internal revenue; but I think the secretary might inform the committee, if he so desires, of how many cases the committee has dealt with, how many are still pending, and how many persons have been disbarred for unethical practices, because it seems to me that that is one of the most important things, if we are going to get honesty in tax administration.

MR. GREGG: We have just begun recently to put into the weekly publication—the bulletin of the bureau of internal revenue—a list of those who are disbarred from practice. I think that is going to be quite effective. This is the first time that has ever been published.

MR. MANSON: I think the publication of that list is about the best warning to the profession generally. I do really believe that that is going to be a very effective thing.

MR. GREGG: It gives the reasons, too.

SENATOR KING: Mr. Chairman, I think this committee could investigate, and we have, to some extent, the methods by which persons are permitted to practise before the bureau of internal revenue on matters of taxation, refunds, etc., and that we could make recommendations. We might not be able to control, or we might not have the right to investigate the general rules in the treasury department with respect to disbarment of attorneys, etc., but certainly we would have cognizance of the question of determining this and for the purpose of recommending to congress some way of finding out who is permitted to practise before the bureau and who is not.

It has occurred to me, as these proceedings have gone on, that it might be wise, and I think the committee should consider that, and the department should prohibit anybody from practising before the bureau who was not a lawyer of experience, high standing, and of fine character. I doubt the wisdom of permitting mere experts, and particularly those who have gone out and opened the books and made up the accounts of a concern, to come before the department as attorneys. That certainly is not ethical in law. A lawyer is not an accountant; he is not an expert. The experts may be called as witnesses to testify, but they are not lawyers, and I doubt the propriety of admitting merely licensed experts and accountants to practise before the department.

MR. NASH: Mr. Chairman, this subject came up before you when the committee first began its sessions, and I think at that time I furnished to the committee a list of attorneys and accountants who had been admitted to practise before the department, and also furnished a copy of the departmental rules and regulations.

THE CHAIRMAN: I think that is correct. I remember that, but I have more in mind the procedure which has been adopted by the committee on enrollment and disbarment, how many have been refused and how many have been disbarred, and all of that, and because that, it seems to me, would give us a picture of just how effective and efficient this committee was. I have a very great doubt in my own mind as to the effectiveness of this committee. I doubt whether it is very effective at all.

MR. MANSON: I believe that there is one suggestion made in the report of Mr. Parker that I just read which is a very vital one, and that is that if any employee of the department feels that a representative of the taxpayer, a licensed representative of the taxpayer or an enrolled representative of the taxpayer, is engaging in unethical practice that employee should have the means of making his complaint directly to the committee on enrollment and disbarment and not be under the necessity of making it through his section chief and his section head and so on up the line.

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MR. MANSON: If a practitioner is engaged in an unethical practice without casting any particular reflections on anybody, he necessarily has to have the coöperation of his section chief or division head, and it does not seem that either a section chief or a division head should be in a position to head off a complaint.

MR. NASH: Mr. Chairman, I do not know personally that there is any rule that would prevent an employee from reporting to the committee on enrollment and disbarment any attorney or accountant whom he thought was guilty of an unethical practice. I agree with Mr. Manson's suggestion that if there were such a rule—

THE CHAIRMAN: It isn't a matter of whether there is a rule against it or not; the whole proceeding is a sort of a military affair; they must step up to the chief of the section. The employees should know that they could take such matters over the heads of their chiefs, and it ought not to be a negative matter, but it should be an affirmative matter that should be required of them.

MR. MOSS: Mr. Chairman, my own opinion is that the way should be made easy for any proper information to reach this committee on enrollment and disbarment as to the unethical practitioner. I know that that is the great desire of the secretary and the commissioner of internal revenue—to get at every one of these cases, if they can do it. I have no doubt that the committee would be somewhat interested in knowing what has been accomplished. What remains to be accomplished simply shows the bigness of the job to keep these fellows out.

On the question of your authority, if you will permit me to suggest it, I am inclined to believe that the general authority under your senate resolution to investigate the bureau of internal revenue for the purpose of offering amendments to the law or correcting the procedure would carry with it authority to inquire as to how men obtain permission to practise there. It would seem to me almost necessarily so.

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SENATOR KING: If they think it is wise to have large accounting firms take over the handling of the books of large concerns, rewriting their books from the beginning, and then present their returns for taxation purposes to the department, and then become the attorneys for the concerns which they have represented as bookkeepers, as accountants, and as experts, in order to try to avoid paying a tax, or in order to recover taxes after they have been assessed by the department; or whether experts and accountants ought to be regarded as experts and accountants and not as lawyers and denied the right to practise in the department, particularly where they are urging as lawyers accounts which they have made up as experts and accountants for big taxpayers?

Mr. Nash: Senator King, accounting is just as much a part of tax practice as law is. The department must recognize both accountants and lawyers. Every tax case will probably present as many accounting problems, or more, than it will legal problems. Very few lawyers are also accountants. The board of tax appeals recognizes both lawyers and certified public accountants. Treasury regulations do not limit practitioners to certified public accountants, but they recognize any accountant. They also recognize employees of a firm or the officers.

Mr. Moss: Agents.

Mr. Nash: Also the agents of a firm.

I do not see anything harsh in having an accountant go into a business and adjust the accounts and present an amended tax return, if he has an honest case. If he has complied with the law and the regulations, and the taxpayer has overpaid his tax, he certainly is entitled to get his money back.

Senator King: Undoubtedly.

Mr. Nash: An accountant is a sort of a doctor to a business. If a taxpayer has made an erroneous report, or is not keeping his books properly, and the books do not correctly reflect the income, the accountant's job is to adjust the accounts and, at the same time, correct any errors that have been made in the tax return. Honest accountants adjust taxes up as well as down. We have many cases on the basis of accountants' reports before us, where they have made examinations and amended returns have been submitted by taxpayers and additional taxes have been paid.

Accountants Necessary in Tax Practice

The remarks of Mr. Nash just quoted should do much to offset the opinion, which was expressed by Senator King and has been a rather common article of faith among certain lawyers, that it is unnecessary to permit accountants to represent taxpayers in disputes concerning tax incidence. It would be almost as absurd to urge that lawyers should be prevented from presenting legal cases as that accountants should be excluded from participation in the hearing of financial cases. The ordinary lawyer knows nothing whatever of accounting and can not be expected to do justice to the interests of his client or of the government in matters which involve accounts. Of course, many members of the legal profession have recognized the facts and the most reputable of them do not attempt to deal directly with questions of accounting technique. But it is just as well that comments such as those of Mr. Nash should be widely known. The speaker might have added that a lawyer is by nature and training an advocate and advocacy is a thing which does not always lead to strict equity. The accountant, on the other hand, with his experience in the presentation of facts is far more likely to do justice to both sides. He is, in a word, the ideal exponent of the truth in such cases as those which come before the bureau of internal revenue or the board of tax appeals, and it is idle to suppose that he can be excluded without serious injury to the cause of fair play.

Other Quotations of Interest

The committee then gave some consideration to the possibility of collusion between employees or former employees of the bureau and unscrupulous persons engaged in tax practice. The chairman, Senator Couzens, said:

As in the case of an estate that we had before us awhile ago, there are employees of the bureau who know that cases are pending, and on account of court decisions can get a reversal, and they can go out and stir up all of these claims against the government on a percentage basis. I do not know; I am not convinced of any particular methods that you can adopt to stop that practice, but it is certain that the greatest degree of vigilance should be used to prevent that sort of thing.

MR. NASH: Senator, in that estate-tax case, those former employees of the bureau were not admitted to practise before the bureau, and have never been admitted to practise, and the bureau is vigorously investigating them and will try to prosecute them.

THE CHAIRMAN: I think that is true, and I point that out with no intention to criticize the bureau, but merely to show the possibilities that these men have who work within the bureau.

MR. GREGG: We recognize the possibilities, Mr. Chairman, and we have done everything we can to stop it. Let me give you some of the difficulties, however.

The principal difficulty is caused by the taxpayer himself. If some one comes to a taxpayer and boasts about having inside information with reference to his case, and wants to take his case on a contingent basis, the ordinary, honest taxpayer will tell him "Nothing doing," but he will not give us the facts.

THE CHAIRMAN: Why not?

MR. GREGG: They seem to have a feeling that it may prejudice their case in some way.

There are lawyers who come to me time and again and tell me about such and such a thing happening, that an ex-employee approached a client of theirs, saying that he had inside information, or something of that sort. The lawyers tell me that they try to get their clients to give us the information. Of course, the lawyer can not do that, without the permission of the client, and the client will not do it for fear it will harm his case. Occasionally, they will. Occasionally they will work right with us in a case.

THE CHAIRMAN: I think undoubtedly the press takes that attitude too, does it not? I mean the press takes the attitude that any criticism that is addressed might hurt their case before the bureau?

MR. GREGG: Well, I do not know about that, but I have seen the other cases. Sometimes they do it, and it does a great deal of inconvenience to them. Sometimes they coöperate with our intelligence men. We had a case the other day where they had to make false affidavits, with the knowledge of our intelligence men, upon the advice of these so-called experts who approached them. Finally, through the coöperation of the taxpayer, we had them indicted. But it is very difficult to get taxpayers to coöperate with us in these cases.

I think you will find that it has not only been impossible for us to keep undesirables from practising before the bureau, but the courts have had the same experience. You all know that there are shyster lawyers who are practising before the courts. It is impossible for the courts to keep unethical and crooked practitioners out of the courts and, of course, it is going to be impossible for us to do it.

THE CHAIRMAN: What could the bureau do in a case like this, for instance: In going over the record of one of the cases in the bureau, I find a case where Mr. Doheny employed one of your staff, while he was still an employee of the bureau. He accepted Mr. Doheny's offer, and then had the nerve to ask for two weeks' leave of absence, and he wanted pay from both sources, pay from the bureau and pay from Mr. Doheny. The bureau properly took the position that he could not be on both pay rolls. That man, of course, could go to Mr. Doheny or Mr. Sinclair, or any other big interest, and convey to them all the intricacies of discovery valuation and depletion and the maximum results to be derived by the most favorable decision for his employer.

There is nothing under the law that can stop that, is there?

MR. NASH: He can not actively appear on any of their tax cases for a period of two years.

THE CHAIRMAN: Oh, I understand that; but he can remain in the office and feed them all of the information?

MR. GREGG: If he does that, we can not stop him.

THE CHAIRMAN: No; that is one of the difficulties.

MR. GREGG: Neither can you stop a man in court from appearing on both sides of the case, if he does it in a backhanded manner.

MR. MANSON: At least he can not do it in open court where everybody is looking at him.

MR. GREGG: No; but he may be working in the interest of the other party on the outside.

MR. NASH: In this particular case I think his personal record would be so noted as to prevent a reinstatement in the treasury department if he ever should seek reappointment, because of the conditions under which he resigned. If he should ever seek employment elsewhere and refer to the treasury department for a reference, the conditions under which he left the treasury department would be made known.

MR. MOSS: Mr. Chairman, let me make this suggestion for Senator King's serious consideration, in view of his statement awhile ago as to the exclusion of auditors and accountants, that the committee should very seriously consider the danger of suggesting to congress a rule, because of a few bad cases, a rule which would operate against very many hundreds of perfectly honest accountants and auditors, and the very many thousands of taxpayers who are entitled to the services of these auditors and accountants. We can not legislate always for the rascal. You have to legislate for the average run of people, and I think, Senator King, you may want to think about that a little further. I doubt very seriously the advisability of adopting anything that would look to the exclusion of auditors and accountants with relation to the taxpayer. A taxpayer may not want to hire a lawyer, but just wants to send an agent here to Washington to explain things.

MR. GREGG: In that connection I would like to bring out the fact that in England any tax report of a firm of accountants is accepted by the revenue department. No field examinations are made at all and, except in the case of fraud or something of that sort, the accountant's report is accepted as to the facts stated in it.

MR. MOSS: In the absence of a showing of fraud.

MR. GREGG: In the absence of a showing of fraud, or something of that sort.

MR. MANSON: In that connection, I would like to call Mr. Gregg's attention to the fact that accounting in Great Britian has been a recognized profession, subject to the most rigorous regulation, for over a century; that it has traditions behind it as a profession; that in this country we had no real accountants for a great many years, except those who had trained in England or Scotland. and without casting any reflection on individuals, the accounting profession in this country is a thoroughly new profession, as such, and a large part of its personnel is made up of men who have acquired their license under the provision of the recent laws which permits all of those to be made certified public accountants who have been in actual practice for a certain period of years. In other words, in England, the profession of accounting has a hundred years of tradition behind it.

SENATOR KING: But what I had in mind when I made the suggestion was merely tentative. I did not mean to commit myself to it as a policy, but the evidence which we have had here is that some of these accountants, for a contingent fee, offer their services to get all of the reduction that they can bring about under the head of amortization; so that they are more than accountants. They have a specific and direct interest in securing reductions. They have a financial interest; the amount of their fee depends on how they can arrange those books—and I do not use those words offensively—so as to secure large amortization reductions, etc.

MR. MANSON: I believe you have a regulation, have you not, which provides that any representative of a taxpayer who has a contingent-fee contract shall file a copy of the contract with the treasury department?

MR. NASH: Yes; he discloses his contract, and it becomes a part of the file in the case. If his contingent fee is considered abnormal to what is involved in the case, he is not permitted to appear in the case.

MR. MANSON: That is a fairly recent regulation, is it not?

MR. NASH: It was adopted about two years ago.

What the Treasury Might do

The foregoing discussion is of value as an illustration of the state of mind of some who have to do with the making and administration of tax laws. Mr. Manson scarcely does justice to the remarkable progress which has been made by the profession of accountancy in the United States during recent years. It is true that the profession is longer and better established in Great Britain and it is also true that the prospects of high emolument here have attracted, particularly in the field of tax practice, a good many undesirable citizens, but we do not believe that there is a higher standard of professional behavior in any country than there is here, taking the profession as a whole. Mr. Manson might have said—but as he did not we crave permission to say it for him—that the code of ethics laid down and enforced by the American Institute of Accountants is more exacting than any other professional code of which we have knowledge. For example, the treasury department will permit contingent fees in tax practice if the extent of the fee is made known and is believed to be reasonable. The Institute goes further and absolutely forbids any of its members to accept contingent fees of any kind or amount. When the treasury department issued a ruling to the effect that practitioners before the bureau must conform to the standards of ethics laid down by the American Institute of Accountants and the American Bar Association it made a fine gesture which should have been followed by action. Let the treasury department absolutely forbid anyone to present a case for which a fee contingent upon results is to be charged; let it enforce such a rule; let it deal promptly and impartially with every practitioner accused of unethical procedure—in a word, let the treasury live up to what it evidently knows to be the correct standards and the whole difficulty will be swept away. The treasury can not blame anyone but itself if it permits men or women to practise before it who fall short of the best professional ideals.

AMERICAN INSTITUTE OF ACCOUNTANTS

TRIAL BOARD

A special meeting of the council of the American Institute of Accountants was held at Washington, D. C., February 1, 1926. The meeting was called for the purpose of hearing charges preferred against a member of the Institute.

The council immediately convened as a trial board and Leslie N. Simson, New York, accompanied by counsel, appeared before the board in answer to charges alleging a violation of rule 2 of the rules of professional conduct through the negligent certification of a balance-sheet of the Ferguson-McKinney Manufacturing Company of St. Louis, Missouri, dated February 28, 1925.

After full consideration of the charges presented on behalf of the Institute by the chairman of the committee on professional ethics and of the statements and explanations made by the respondent, the board by unanimous action found the respondent guilty of a violation of rule 2 of the rules of professional conduct through the negligent certification of the balance-sheet above referred to and resolved that he should be suspended from membership in the Institute for a period of one year. It was further resolved that in publication of the finding of the trial board in THE JOURNAL OF ACCOUNTANCY the name of the respondent should appear.

Charges against an associate which were to have been heard at the meeting were postponed for hearing at a subsequent meeting of the council. The deferment was due to certain information received since the filing of charges, and it was resolved that further investigation should be made before the case should come to trial.

The meeting having been called solely for the purpose of hearing charges no other business was transacted.

Income-tax Department

EDITED BY STEPHEN G. RUSK

"Death and taxes" are inevitable with mankind. The contemplation of both or either one of them is not listed among mankind's pleasurable pursuits. Consequently it is not astonishing that so little is said in appreciation of the really wonderful constructive work performed by the commissioner of internal revenue and the bureau over which he reigns. To them falls the difficult work of solving the problem of interpreting and applying the law enacted by a more or less intelligent congress. The law as given by the law-makers is in many instances vague as to its purport; it may be sometimes unconstitutional; at other times it is the expression of a feeling that certain portions of our citizenry must be at least handicapped in the interests of some other portion; quite frequently some of its provisions are illogical and uneconomic; and in any event it deals with taxes, and taxes are not popular.

The commissioner, however, takes the rough product and always hewing to the line supplies the amplifying language and the administrative machinery; he clears up the complexities as well as may be done, so that the taxpayer may know what is expected of him. That this is a monumental task is impressed upon us at this particular time, when a new law is in the process of being formed within a few days of the time that it is to be applied, and as this thought is being considered, another presents itself: the problems heretofore confronting the commissioner in endeavoring to apply certain unworkable features of former laws.

One of the particularly aggravating problems of the past had to do with the section of the laws wherein congress, in its wisdom, sought to tax stockholders with the undistributed profits of corporations.. Another is the problem of obtaining information at the source of income of taxpayers. A number of others could be cited, but the foregoing are sufficient to fortify the contention that the commissioner's lot is not a happy one.

If the bureau of internal revenue collects data from the source of every payment to an individual of salary, rent, commission, royalty or other form of compensation, in excess of $800 per annum, it must have a tremendous accumulation of papers. If this information is made available to the department of the bureau upon which devolves the task of auditing the returns, and if the information so collected and distributed is used in verifying some seven or eight million taxable incomes, it is fair to say that the commissioner should have our unbounded appreciation. Washington is a beautiful city with many monumental buildings, and it is a pleasure to visit them. A curious person some time is going to hunt up the large building in which are kept the papers containing the "information at the source" and we believe that he will be astounded at the ingenious mechanics of sorting, distributing, verifying and comparing this information with the taxpayers' returns. If and when he does view this work, our curious one is going to be thankful that he is just a taxpayer and has not the responsibility of the commissioner.

If the recommendation of the representatives of the American Institute of Accountants to the ways and means committee that withholding and payment of taxes at the source be abolished is adopted, it is to be hoped that congress also will see the error of its ways and abolish the collection of information at the source.

In its endeavor to close the door to the relatively small portion of the taxpaying public that seeks to evade taxes, congress has adopted some cumbersome, awkward and, at times, unworkable methods, but in the matter of collecting information at the source, the task put upon the commissioner seems one beyond possibility of performance. If he should consider the particular provisions appertaining to this as a "dead letter", who would blame him? There must have been instances where this information has not been supplied by the taxpayer, but we know of none where notice of the lack of it has been taken.

When one recalls the work performed by the last two commissioners and their assistants in administering the new laws; the vagueness and complexities of these laws; the huge amounts of the taxes collected by the commissioner's agencies with comparatively little friction, one must be impressed by the accomplishments of the department and its officers. If taxes were more esteemed by the public, those who administer tax laws would probably receive more adequate public recognition.

SUMMARY OF RECENT RULINGS

A municipal office, the income of which is exempt from tax, is a public station created by law, permanent in character, and the incidents and duties of which are prescribed by law. A municipal employee whose income is exempt is one over whom the employer has the right of control as distinguished from employment of an independent character.

Those agencies through which the federal or state government exercises its sovereign power are immune from the taxing power of the other, but a person is not exempt on the sole ground that his income is compensation for services rendered the state. (United States supreme court, *Metcalf & Eddy, copartners*, v. *Mitchell, collector*.)

The word "debts" in section 3466, R. S., includes taxes, and the government is given priority therefor in voluntary assignments, though the pleadings alleged taxpayer was solvent, the facts being otherwise. (United States supreme court, *Leo Price, receiver*, v. *United States*.)

A corporation distribution occurs when a dividend is declared, not when paid, and the 1916 rates apply to dividends declared in 1916 and in January, 1917, when no profits were earned in said month and the existing undivided profits or surplus were adequate.

Fair market value of stock may not be determined from exchange prices when

1. The corporation control remained with the original stockholders,
2. It owned valuable contracts and goodwill,
3. Bona fide offers in excess of such stock-exchange prices had been received for the controlling interest, and
4. A trust agreement limited the sales of the stock.

(United States district court, W. D., Pennsylvania, *B. D. Phillips* v. *United States*.)

Bad debts were held to be deductible where the amounts which may be received from the debtors about equal taxpayer's indebtedness as surety for them, although (1) worthlessness has not been determined by legal action, (2) debtors are corporations controlled by taxpayer, and (3) only a part of such debts is claimed as a deduction. (United States district court, W.D., Pennsylvania, *Selden* v. *Heiner*.)

A net loss deductible for the income of the preceding year under the 1918 act is not sustained by one who suffers a loss on sale of property not contributing to the prosecution of the war. (United States court of claims, *Auburn & Alton Coal Co.* v. *United States*.)

A federal court receiver is not an officer or employee of the United States whose income is exempt from tax under section 201 (a) of the 1917 act, and his services may constitute a trade or business within the meaning of section 200 of the act, depending upon the amount of time and attention required. (United States district court, S.D., New York, *Fleming* v. *Bower*.)

Amount paid to an accountant for preparing an individual federal tax return not deductible. (B. T. A. decision 1099, docket 2116, Charles H. Mattlage.)

The commissioner has five years from the date of filing a delinquent return due under the 1918 act within which to assess the tax. (B. T. A. decision 1101, docket 4566, J. P. Bell.)

Cost of transporting serviceable vessels purchased to another port for repairs and changes and to be placed in service there, was held to be a business expense. B. T. A. decision 1102, docket 3168, Northern Michigan Transportation Co.)

Proceeds of "use and occupancy" insurance is income in the year for which it is compensation, where taxpayer is on accrual basis, though received in subsequent year.

Proceeds of "use and occupancy" insurance not proceeds of involuntary conversion under section 214 (a) (14), act of 1921.

Where separate properties are separately insured, taxpayer may treat the gain on one policy as subject to involuntary conversion provisions and deduct the loss on another.

Invested capital is properly reduced where an amortization deduction is made. (B. T. A. decision 1108, docket 2322, International Boiler Works Company.)

Litigation expenses incurred by a husband in defending a post-nuptial property agreement is a personal expense, though his sole business was the management of his estate. (B. T. A. decision 1139, docket 476, David G. Joyce.)

Where one corporation owned all the common stock and approximately 67 per cent of the preferred stock of another corporation, they were affiliated under the act of 1918. (B. T. A. decision 1146, docket 3346.)

TREASURY RULINGS

(T. D. 3791, December 21, 1925)

ARTICLE 1351: Suits for recovery of tax erroneously collected.

Income Tax—Suit to Restrain Payment—Decision of Court

INJUNCTION—DISTRAINT—HOMESTEAD—SECTION 3224, REVISED STATUTES.

> Under the provisions of section 3224, *Revised Statutes*, an injunction will not lie against a collector of internal revenue to restrain the collection of an income tax legally assessed, although warrant of distraint was levied against a homestead.

The following decision of the United States district court for the northern district of Texas, in the case of *Staley* v. *Hopkins et al.*, is published for the information of internal-revenue officers and others concerned.

DISTRICT COURT OF THE UNITED STATES FOR THE NORTHERN DISTRICT OF TEXAS, AT DALLAS. IN EQUITY.

C. R. Staley, plaintiff, v. *George C. Hopkins and B. F. Crews, defendants.* [November 25, 1925.]

MEEK, district judge: The plaintiff, C. R. Staley, filed his bill of complaint against George C. Hopkins and B. F. Crews, seeking to have the defendants restrained and enjoined from selling his homestead, which is occupied by himself and family, in Vernon, Wilbarger county, Texas.

Upon reading the plaintiff's bill I granted a restraining order, directing the defendants, George C. Hopkins and B. F. Crews, not to sell plaintiff's homestead, as it had been advertised for sale, but instead to appear before the court and show cause why the temporary injunction and the permanent injunction prayed for should not be granted.

Mr. George C. Hopkins, collector of internal revenue, and B. F. Crews, his assistant, have appeared and filed their answer to the bill of plaintiff and asking that such bill be dismissed.

The plaintiff and the defendants have appeared and their counsel have made arguments in support of their respective contentions.

After duly considering their arguments in connection with the briefs submitted by them, I have decided that because the sale of this homestead is for the purpose of paying an income tax levied against Mrs. Staley, wife of the plaintiff, and because of the provisions of section 3224 of the *Revised Statutes* of the United States, which is as follows: "No suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court," and in view of the rulings of the United States supreme court upon this section of the *Revised Statutes*, I have decided that plaintiff has not the right to maintain this bill and is not entitled to the relief prayed for therein. Therefore this bill is dismissed and the costs of this proceeding shall be taxed against him.

Institute Examination in Law

By Spencer Gordon

[The following answers to the questions set by the board of examiners of the American Institute of Accountants at the examinations of November, 1925, have been prepared at the request of The Journal of Accountancy. These answers have not been reviewed by the board of examiners and are in no way official. They represent merely the personal opinions of the author.—*Editor*, The Journal of Accountancy.]

EXAMINATION IN COMMERCIAL LAW

November 13, 1925, 9 a. m. to 12:30 p. m.

Correct answers to each question in group I will be awarded 2 points; the questions answered satisfactorily in group II will each be entitled to 10 points.

GROUP I

Answer each of the following ten questions by "Yes" or "No":

1. Is a compromise with creditors a sufficient consideration for a contract?
2. Is an instrument made payable to "James G. Kelly or Charles Perkins" negotiable?
3. Is it possible for a partnership to exist between parties who do not consider themselves partners?
4. Can a promisor assign his liabilities under a contract?
5. Will the discharge in bankruptcy of a surety on a bond release him from liability to his co-surety who has discharged the bond liability upon its accrual subsequent to the discharge?
6. Can a corporation be organized without capital stock?
7. Can a man who pays $400.00 offered and accepted in discharge of a debt of $500.00 be held liable to pay the balance?
8. Is a party who purchases a past due note a "holder in due course"?
9. Can execution on a judgment against a copartnership be immediately levied on property of one of the partners?
10. The drawer of a cheque has it certified and delivers it to the payee. In the afternoon of the same day the bank fails. Can the payee collect from the drawer?

Answer:

1. Yes.
2. No.
3. Yes.
4. No.
5. No.
6. Yes.
7. Yes.
8. No.
9. Varies in different states.
10. No.

GROUP II

Answer eight of the following questions, giving reasons for all answers:

1. Name four vital elements of a valid contract.

Answer:

An agreed valid consideration; an expression of mutual assent of the parties to a promise or set of promises; parties of legal capacity; and the agreement must not be declared void by statute or common law.

2. A corporation bankrupt has assets converted into cash by the trustee amounting to $285,000. There is outstanding $100,000 of common stock, $50,000 of preferred stock. Corporate bonds total $75,000, taxes owing amount to $8,000 and claims of creditors aggregate $150,000. How will the cash be distributed?

Answer:

The bonds, taxes and claims of creditors in all aggregating $233,000 will first be paid. This will leave $52,000. How this is to be divided will depend upon the certificate of incorporation and stock certificates. It is quite customary to have the assets payable first to the holders of preferred stock. In that case they would get $50,000 and $2,000 would be divided pro rata among the holders of the common stock. In the absence of an express provision, however, the $52,000 would be distributed pro rata among the $150,000 holders of the combined common and preferred stock.

3. A retail furniture dealer has a business with customers throughout a certain county, but makes no sales outside that county. He sells his entire business and agrees with the purchaser that for a period of five years he will not engage in the furniture business anywhere in the state. Is such agreement enforceable under common law?

Answer:

Under the early English common law such a contract would be void as a restraint on trade. The present rule is that it is only void if it is an unreasonable restraint. If the agreement had been not to engage in the furniture business anywhere in the county it would undoubtedly be valid as a reasonable restraint of trade and one which was necessary in order to sell the goodwill. Probably the same holding would be had in spite of the fact that the agreement covers the entire state. If, however, the agreement covered the entire world it would be unreasonable and void.

4. Give four powers possessed by a corporation that are not possessed by a copartnership.

Answer:

Limited liability of stockholders; legal entity and continued existence in spite of death of stockholders; power to own; power to sue and to be sued.

5. Write a form for a negotiable instrument, pointing out each essential element therein.

Answer:

January 1, 1926. Four months after date, I promise to pay to the order of John Smith $100, with interest at 6% per annum. (Signed) William Brown.

The essential elements are as follows:

(a) It is in writing.

(b) It is signed by the maker (William Brown).

(c) It contains an unconditional promise to pay a certain sum of money ($100 with interest at 6% per annum from January 1, 1926).

(d) It is payable at a fixed future time (four months after January 1, 1926).

(e) It is payable to "order" (to the order of John Smith).

6. Geller owed Gordon $650, which was past due. After some negotiation between the parties as to payment Geller offered $150 and an automobile worth approximately $400 in full satisfaction of the debt. Gordon accepted. Was the debt discharged?

Answer:

The debt was discharged. This question differs from question 7 in group I in that the value of the automobile is not liquidated or definite in dollars and cents. Where something other than money is accepted the law will not look into the adequacy of the consideration.

7. Have special agreements between partners as to partnership affairs any effect upon contracts between the partnership and other parties?

Answer:

Special agreements between partners as to partnership affairs have no effect upon contracts with other parties unless the other parties have notice of the special agreements. The other parties can assume that the usual relation of partners obtains.

8. What are personal defenses to a negotiable instrument? What are absolute defenses? To whom are these defenses available?

Answer:

Personal defenses are those which are cut off by the transfer of the instrument to a holder in due course. Absolute defenses are those which can not be so cut off. An illustration of a personal defense is where a note was procured by fraud of the payee. The maker might defend on that ground, but if the note was transferred to a holder in due course the defense would be lost. An example of an absolute defense is forgery of the name of the maker.

9. Explain the following: bill of sale, statute of frauds, stoppage in transitu.

Answer:

A bill of sale is a writing signed by the seller of personal property describing the property and giving the terms of sale.

The statute of frauds provides that certain deeds, contracts and conveyances must be in writing in order to be valid. It differs in various jurisdictions but generally provides that no estate in lands (except short leases) may be created except by deed, and that contracts of suretyship, contracts of sale of lands, contracts not to be performed within a year, contracts for the sale of goods above a certain price and contracts in consideration of marriage must be in writing.

Stoppage in transitu is the right of one who sells goods on credit to recover possession of such goods while they are in the hands of a carrier or middleman in transit to the consignee or purchaser in case the purchaser has become insolvent.

10. What is the cumulative system of voting by stockholders and what are its advantages?

Answer:

Under the method of cumulative voting each stockholder is entitled to as many votes for directors as equal the number of shares he owns multiplied by the number of directors to be elected. This enables minority stockholders to elect a minority of the directors.

11. What is a common carrier? A bill of lading? Is a bill of lading negotiable?

Answer:

A common carrier is one who undertakes for compensation to transport such persons, or their goods, as choose to employ him.

A bill of lading is a writing issued by the carrier to the consignor consisting of a receipt for the goods and an agreement to carry them from the place of shipment to the place of destination. A bill of lading is not negotiable as is a draft or note. In practice it passes from hand to hand, to some extent representing the goods.

12. What is meant by affiliated corporations under the income-tax law?

Answer:

Two or more domestic corporations are deemed to be affiliated (1) if one corporation owns at least 95 per centum of the voting stock of the other or others or (2) if at least 95 per centum of the voting stock of two or more corporations is owned by the same interests. A corporation organized under the China trade act of 1922 shall not be deemed to be affiliated with any other corporation within the meaning of this section. A corporation entitled to the benefits of section 262 of the revenue act of 1924 is treated as a foreign corporation for purposes of affiliation.

Students' Department

EDITED BY H. A. FINNEY

ASSISTED BY H. P. BAUMANN

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 unofficial opinions of the editors of the *Students' Department.*)

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART II

NOVEMBER 13, 1925, 1 P. M. TO 6 P. M.

The candidate must answer all the following questions.

No. 1 (35 points):

From the following data, prepare an application of funds statement for the calendar year 1924.

X Y Z COMPANY

Assets	December 31 1923	December 31 1924	Increase or Decrease *
Current assets:			
Cash in banks and on hand...	$152,928.16	$221,314.90	$68,386.74
Notes receivable..........	41,368.00	85,618.20	44,250.20
Accounts receivable, less reserve for bad debts.......	249,628.30	378,920.62	129,292.32
Due from affiliated companies.	116,283.25	146,962.18	30,678.93
Inventories...............	896,762.80	950,319.60	53,556.80
	$1,456,970.51	$1,783,135.50	$326,164.99
Deferred charges:			
Unamortized bond discount..		$36,000.00	$36,000.00
Other deferred charges......	$29,615.25	47,837.90	18,222.65
	$29,615.25	$83,837.90	$54,222.65
Investments:			
Affiliated companies........	$643,828.76	$668,828.76	$25,000.00
Outside investments........	227,396.40	208,316.80	19,079.60*
	$871,225.16	$877,145.56	$5,920.40
Fixed assets:			
Land, buildings, machinery, equipment, etc...........	$2,392,875.40	$3,380,317.90	$987,442.50
Less, reserve for depreciation	465,928.15	562,928.62	97,000.47
	$1,926,947.25	$2,817,389.28	$890,442.03
	$4,284,758.17	$5,561,508.24	$1,276,750.07

Liabilities and net worth	December 31 1923	1924	Increase or Decrease *
Current liabilities:			
Accounts payable..........	$215,962.10	$127,824.11	$88,137.99*
Notes payable.............	230,000.00	170,000.00	60,000.00*
Dividends payable.........	68,048.50	79,138.75	11,090.25
Accrued interest, taxes, etc...	87,368.20	96,218.90	8,850.70
	$601,378.80	$473,181.76	$128,197.04*
Assets			
Ten year 6% gold bonds dated January 1, 1924..........		$500,000.00	$500,000.00
Reserves:			
Employees' pension fund....	$2,619.30	$3,500.80	$881.50
Dredging reserve...........	6,927.60	7,317.19	389.59
Contingencies..............	120,615.40	122,876.45	2,261.05
	$130,162.30	$133,694.44	$3,532.14
Net worth:			
Capital stock, preferred......	$174,200.00	$236,500.00	$62,300.00
Capital stock, common......	2,600,000.00	3,000,000.00	400,000.00
Capital surplus............		479,326.19	479,326.19
Earned surplus.............	779,017.07	738,805.85	40,211.22*
	$3,553,217.07	$4,454,632.04	$901,414.97
	$4,284,758.17	$5,561,508.24	$1,276,750.07

On January 1, 1924, the company issued $500,000 par value 6% gold bonds due January 1, 1934. The bonds were sold at 92, the discount deferred to be amortized over the life of the bonds.

Outside investments included stock in the B company which cost $55,000. The B company failed during 1924 and the stock was sold for $5,000. The loss was charged to the reserve for contingencies. Other worthless outside investments, carried on the books at $10,000, were absorbed in the current profit and loss. Other charges in this account may be attributed to the sale of securities at their book value of $15,000 and the purchase of other securities.

An appraisal of the plant as of January 1, 1924, taken up on the books as at that date, resulted in a considerable increase in the sound book value. The appreciation arising therefrom amounted to $496,452.69 and was credited to capital surplus. Extensive additions and improvements were made from the proceeds of the bond issue. Depreciation was computed upon the appraised property values and amounted to $132,716.90 for 1924. It was found that $17,126.50 of this amount represented depreciation on the appreciation element in the book value of the fixed assets and this depreciation on appreciation was carried to capital surplus. A brick storehouse was abandoned and torn down in order to make room for plant extensions. The original cost of this building, $30,000, had been entirely written off to depreciation reserve and the salvage, after removal costs, amounted to $5,000. Actual expenditures for renewals and replacements charged directly to the depreciation reserve amounted to $10,716.43.

In addition to the worthless securities charged to contingencies reserve, a federal tax assessment for the year 1920, amounting to $47,738.95, was charged thereto. As a result of these unusual charges, the directors voted to appropriate $100,000 of surplus to increase this account. A charge of $1,200 was made against the pension reserve and $4,560.90 against dredging reserve.

On July 1, 1924, a common stock dividend was declared which increased the stock outstanding to $3,000,000.

The cash dividend transactions of the company were as follows:

Preferred	Common	Date declared	Date paid
$3,048.50	$65,000.00	Dec. 31, 1923	Jan. 15, 1924
3,325.00	65,000.00	Mar. 31, 1924	Apr. 15, 1924
3,500.00	65,000.00	June 30, 1924	July 15, 1924
3,717.00	75,000.00	Sept. 30, 1924	Oct. 15, 1924
4,138.75	75,000.00	Dec. 31, 1924	Jan. 15, 1925

Net profit for the year, carried to surplus, was $754,469.53.

Solution:

This problem contains so many complications and serves so excellently to illustrate the intricacies in which the preparation of a statement of application of funds may be involved, that it is thought that possibly more than a mere solution of the problem should be presented, and that advantage should be taken of the opportunity which the problem affords to discuss the theory of the statement and the working papers which may be employed to assemble the figures for its preparation.

The broad theory upon which the statement of application of funds is based is that increases in assets and decreases in liabilities during a period require the expenditure or application of funds, while decreases in assets and increases in liabilities and capital produce funds. If a statement of application of funds were prepared solely on the basis of this theory, without consideration of qualifications to be later considered, the statement would appear somewhat as follows:

X Y Z Company

Statement of application of funds for the year ended December 31, 1924

Funds provided:			
By increase in capital:			
Increase in:			
Capital stock, preferred	$62,300.00		
Capital stock, common	400,000.00		
Capital surplus	479,326.19		
		$941,626.19	
Less decrease in earned surplus		40,211.22	
			$901,414.97
By increase in liabilities:			
Ten year 6% gold bonds			500,000.00
Current liabilities:			
Dividends payable		$11,090.25	
Accrued interest, taxes, etc.		8,850.70	
			19,940.95
Reserves:			
Employees' pension fund		$881.50	
Dredging reserve		389.59	
Contingencies		2,261.05	
			3,532.14
By decrease in assets:			
Outside investments			19,079.60
Total funds provided			$1,443,967.66

Funds applied:

To increase in assets:		
Cash........................	$68,386.74	
Notes receivable..............	44,250.20	
Accounts receivable, less reserve..	129,292.32	
Due from affiliated companies...	30,678.93	
Inventories...................	53,556.80	
Deferred charges:		
Unamortized bond discount...	36,000.00	
Other deferred charges.......	18,222.65	
Investments in affiliated companies.....................	25,000.00	
Land, buildings, machinery and equipment, less reserve for depreciation..................	890,442.03	
		$1,295,829.67
To decrease in assets:		
Accounts payable.............	$88,137.99	
Notes payable................	60,000.00	
		148,137.99
Total funds applied........		$1,443,967.66

But the preparation of a statement of application of funds on the foregoing basis ignores the fact that the changes in the balances of the accounts during the period do not represent the true amounts of funds provided and funds applied. The reasons why this is so may be grouped under three headings, and illustrated as follows:

(1) Some changes in account balances are the result of mere book entries which did not produce any funds nor require the application of any funds. Hence the effect of such book entries must be eliminated from the accounts, and the changes in the balances must be adjusted to show what they would have been if such non-fund-producing and non-fund-requiring entries had not been made.

For instance, the plant was appraised as of January 1, 1924, and the appreciation was credited to capital surplus. This entry affected both the plant accounts and the capital-surplus account, but since it was merely a book entry the increase in the plant account resulting therefrom does not represent the result of an expenditure of funds, and the increase in the capital surplus does not represent a provision of funds. The debit increase in the plant account and the credit increase in the capital surplus must hence be reduced by the elimination of this item.

As a further illustration, a stock dividend was paid during the year and recorded by charge to surplus and by credit to capital stock, common, in the amount of $400,000. This dividend was merely a conversion of surplus into stock and no funds were involved. The decrease in surplus has no relation to funds, and the increase in the credit balance of the capital-stock account does not represent a provision of $400,000 of funds. Hence, before a statement of application of funds can be prepared on a proper basis, the credit increase in the stock account must be eliminated, and the debit to surplus must be eliminated.

(2) Some changes in account balances are the result of transactions which did involve a provision or an application of funds, but the amount of the change in the account balance does not represent the amount of the funds provided or applied.

As an illustration, attention is called to the $500,000 increase in the bonds-payable account resulting from the issue of bonds during the year. This transaction did provide funds, but it did not provide $500,000 of funds because the bonds were issued at a discount of eight points, or $40,000, and the issue of bonds consequently produced only $460,000. The credit to bonds does not represent a provision of funds to the amount of $500,000, and the charge to bond discount of $40,000 (subsequently reduced by amortization) does not represent an application of funds; rather, the entries in the two accounts must be taken into consideration together to determine the net amount of funds provided by the transaction.

(3) Some changes in account balances are the result of several transactions; some of which may represent a provision of funds (in the exact amount of the entry therefor, or in a different amount if there was an element of profit or loss); some of which may represent an expenditure or application of funds, and some of which may be merely the result of non-fund entries.

To illustrate, the change in the balance of the outside-investments account is the result of several transactions, as follows:

		Account	Funds provided	Funds applied
Sales of securities:				
B Company—book value of stock	$55,000	$55,000.00		
Loss charged to reserve for contingencies	50,000			
			$5,000.00	
Other securities at book value		15,000.00	15,000.00	
Worthless securities written off		10,000.00	nil	
Total decreases		$80,000.00		
Purchases of securities		60,920.40		$60,920.40
Net decrease in balance of account		$19,079.60		

It should be apparent from this illustration that the change in the balance of the securities account can not properly be shown in the statement of application of funds as a fund provided in the amount of $19,079.60, for an analysis of the account shows that the net decrease is composed of the following elements:

Loss on sales and write-offs	$60,000.00
Funds provided by sales	20,000.00
Total	$80,000.00
Funds applied to purchases	60,920.40
Net decrease in balance	$19,079.60

The preparation of a statement of application of funds is simplified, when there are many items to analyze and adjust, by preparing working papers in which adjustments can be made giving consideration to the three classes of facts which make the mere use of changes in account balances impossible.

By using working papers:

(1) Changes in account balances which are the result of mere book entries can be eliminated by a reversing adjustment entry. For instance, the changes in balances resulting from the charge to plant and the credit to capital surplus can be eliminated by an adjustment debiting capital surplus and crediting plant account.

(2) Changes which are the result of fund-involving transactions but which do not represent the true amount of the fund provided or applied, can be adjusted by a correction of the changed balance. For instance, the bond account shows a credit of $500,000, while only $460,000 of funds were provided. By an adjusting entry of $40,000 charged to bond account and credited to bond discount, the credit balance of the bond account is reduced to the true amount of the funds provided, and the charge to bond-discount account, which did not represent an application of funds, is eliminated.

(3) Changes in account balances which are the net result of miscellaneous transactions and entries therefor, are analyzed into their component elements.

Special provision is made in the working papers for the analysis of surplus, because the change in the balance of this account usually represents the net amount of many entries, including the net profits for the year (fund provided), the declaration and payment of dividends (fund applied), losses or gains on sales of assets (corrections or adjustments of the change in the balance of the asset account to determine the true amount of the fund provided), and write-ups or write-downs in property values (which have no relation to funds and hence must be completely eliminated).

Attention is now directed to the working papers on pages 222, 223 and 224. The balance-sheets at the two dates are entered in the first two columns, and the increases and decreases in the balances are entered as debits or credits in the year's-excess debit and credit columns, the debits representing increases in assets and decreases in liabilities and capital, and the credits representing decreases in assets and increases in liabilities and capital. These two columns are footed to determine, by their equality, that the differences in balances have been correctly computed and entered. The adjustments are then entered in the adjustment columns. The lettered entries in the adjustment columns of the working papers prepared in solution of this problem are explained as follows:

(A) The net decrease in surplus is brought down to a lower line where plenty of space will be available for complete analysis to account in detail for the various items which have resulted in the net decrease.

(B) Bond account is debited and bond discount credited with the $40,000 discount on the bond issue. The results of this entry are: First, the excess credit of $500,000 in the bond account is reduced by the $40,000 debit adjustment, thus leaving a $460,000 credit excess, which is carried out as a credit to the funds-provided column, and second, the $36,000 debit in the bond-discount account is converted into a net credit of $4,000, which is the amount of the discount amortized during the year, and which is given consideration in C.

(C) Bond discount is debited and surplus credited to reverse the entry writing off the amortized discount for the year. The entry made at the end of 1924 to write off $4,000 discount did not represent a provision or an application of funds. The $40,000 entry (B) and the $4,000 entry (C) completely eliminate the bond-discount balance, and the $4,000 credit to surplus reverses an entry in that account which reduced the balance in that account without affecting the funds. It is true that the discount was probably written off by charge to profit and loss instead of surplus, but since the profit-and-loss account has been closed to surplus the result of the the amortization was a reduction of surplus.

(D) Stock of B company having a book value of $55,000 was sold for $5,000, the loss having been absorbed in surplus. Entry (D) is equivalent to the following journal entry:

Outside investments..............	$55,000.00	
Funds provided................		$5,000.00
Surplus......................		50,000.00

It accomplishes the following: Begins the analysis of the investment account to determine the various elements of the net decrease of $19,079.60; sets out as a separate item the amount of funds provided by the sale of the stock (this amount being extended to the funds-provided column); and offsets a debit entry made in the surplus account for a $50,000 loss which changed the balance of the surplus account without affecting the funds.

(E) Worthless securities were written off by charge to profit and loss, and eventually to surplus. This entry reverses the write-off, continuing the analysis of the investment account, and eliminating another non-fund entry from surplus.

(F) Other securities were sold at their book value of $15,000. This adjusting entry continues the analysis of the investment account, and sets out the proceeds of the sale as a separate item, which is carried to the funds-provided column.

The problem states that other securities were purchased, but it does not state the cost thereof. However, our analysis shows (entries D, E, and F) that the account was credited during the year with $80,000, the book value of securities sold; since the balance of the account has decreased only $19,079.60, debit entries aggregating $60,920.40 must have been made to record the purchase of securities, and this amount is carried to the funds-applied column.

(G) This entry reverses the one for $496,452.69 which was made as of January 1, 1924, to write up the plant to the appraised value. It was a mere book entry not affecting funds, and is hence reversed.

(H) Depreciation was provided during the year in the amount of $132,716.90. This decreased the profits and the surplus without reducing the funds

X Y Z COMPANY

Application of funds—Working papers, year ended December 31, 1924

Assets	Balances December 31, 1923	Balances December 31, 1924	Year's excess Debit	Year's excess Credit	Adjustments Debit	Adjustments Credit	Working capital Increase	Working capital Decrease	Funds Applied	Funds Provided
Cash...........	$152,928.16	$221,314.90	$68,386.74				$68,386.74			
Notes receivable..	41,368.00	85,618.20	44,250.20				44,250.20			
Accounts receivable less reserve	249,628.30	378,920.62	129,292.32				129,292.32			
Affiliated companies..........	116,283.25	146,962.18	30,678.93				30,678.93			
Inventories......	896,762.80	950,319.60	53,556.80				53,556.80			
Unamortized bond discount.......		36,000.00	36,000.00		$4,000.00 C	$40,000.00 B				
Other deferred charges.......	29,615.25	47,837.90	18,222.65						$18,222.65	
Investments:										
Affiliated companies.......	643,828.76	668,828.76	25,000.00						25,000.00	
Outside investments.......	227,396.40	208,316.80		$19,079.60	55,000.00 D 10,000.00 E 15,000.00 F				60,920.40	
Land, buildings, etc............	2,392,875.40	3,380,317.90	987,442.50		30,000.00 J	496,452.69 G			520,989.81	
	$4,750,686.32	$6,124,436.86								

Liabilities										
Accounts payable	$215,962.10	$127,824.11	88,137.99				88,137.99			
Notes payable....	230,000.00	170,000.00	60,000.00				60,000.00			
Dividends payable	68,048.50	79,138.75		11,090.25				$11,090.25		
Accrued interest, taxes, etc......	87,368.20	96,218.90		8,850.70				8,850.70		
Ten year 6% gold bonds.........		500,000.00		500,000.00	40,000.00 B					$460,000.00
Reserves:										
Employees' pension fund....	2,619.30	3,500.80		881.50	2,081.50 P	1,200.00 O				
Dredging reserve	6,927.60	7,317.19		389.59	4,950.49 R	4,560.90 Q				
Contingencies..	120,615.40	122,876.45		2,261.05	100,000.00 N	50,000.00 D 47,738.95 M				
Depreciation...	465,928.15	562,928.62		97,000.47	132,716.90 H 5,000.00 K	30,000.00 J 10,716.43 L				
Capital stock—preferred......	174,200.00	236,500.00		62,300.00						62,300.00
Capital stock—common.......	2,600,000.00	3,000,000.00		400,000.00	400,000.00 S					
Capital surplus...		479,326.19		479,326.19	496,452.69 G	17,126.50 I				
Earned surplus...	779,017.07	738,805.85	40,211.22			40,211.22 A				
	$4,750,686.32	$6,124,436.86	$1,581,179.35	$1,581,179.35						
Analysis of surplus:										
Decrease—down			$40,211.22		40,211.22 A					
Bond discount amortized...				$4,000.00		4,000.00 C				
Worthless outside investments written off.........				10,000.00		10,000.00 E				
Realized appreciation......			17,126.50		17,126.50 I					
Depreciation...				132,716.90		132,716.90 H				
Forward			$57,337.72	$146,716.90	$1,352,539.30	$884,723.59	$474,302.98	$19,940.95	$625,132.86	$522,300.00

X Y Z Company

Application of funds—Working papers, year ended December 31, 1924 (*Continued*)

	Analysis of surplus		Adjustments Debit	Adjustments Credit	Working capital Increase	Working capital Decrease	Funds Applied	Funds Provided
Forward	$57,337.72	$146,716.90	$1,352,539.30	$884,723.59	$474,302.98	$19,940.95	$625,132.86	$522,300.00
Appropriations to reserves:								
Contingencies		100,000.00		100,000.00 N				
Pensions		2,081.50		2,081.50 P				
Dredging		4,950.49		4,950.49 R				
Capital-stock dividend		400,000.00		400,000.00 S				
Dividends declared during the year:								
Preferred		14,680.75		14,680.75 T				
Common		280,000.00		280,000.00 U				
Funds provided by profits	891,091.92							891,091.92
	$948,429.64	$948,429.64						
Funds provided by:								
Sale of outside investments				5,000.00 D				5,000.00
Sale of outside investments				15,000.00 F				15,000.00
Sale of brick storehouse salvage				5,000.00 K				5,000.00
Funds applied to:								
Renewals and replacements			10,716.43 L				10,716.43	
Payment of federal tax assessment for 1920			47,738.95 M				47,738.95	
Payment of pensions			1,200.00 O				1,200.00	
Payment for dredging			4,560.90 Q				4,560.90	
Preferred dividends			14,680.75 T				14,680.75	
Common dividends			280,000.00 U				280,000.00	
			$1,711,436.33	$1,711,436.33				
Increase in working capital and deferred charges						454,362.03	454,362.03	
					$474,302.98	$474,302.98	$1,438,391.92	$1,438,391.92

provided by the profits; since it was an entry for a non-fund transaction it is reversed.

(I) But $17,126.50 of the above amount of depreciation represented depreciation of appreciation, which appears to have been charged to capital surplus and credited to earned surplus. Such a transfer from one surplus account to another did not record a fund transaction, and hence the entry is reversed. The effect of entries G and I is to eliminate the net increase of $479,326.19 in the capital-surplus account.

Entries H and I could be combined in a single entry as follows:

Depreciation reserve..............	$132,716.90	
Capital surplus................		$17,126.50
Earned surplus................		115,590.40

(J) A brick storehouse which cost $30,000 was abandoned. The problem states that the entire cost "had been" written off to the reserve. This is interpreted as meaning that the building had been fully depreciated by credits to the reserve, and that when the building was abandoned the cost was written off against the reserve. Such an entry would have affected both the plant and the reserve account without involving any funds, and hence entry J is made to reverse it.

(K) Salvage from the brick building netted $5,000. Nothing is said in the problem as to the account credited therewith; but the analysis of the depreciation-reserve account, accomplished by entries H and J discussed above, and L discussed hereafter, shows that the net increase of $97,000.47 has been fully accounted for with the exception of $5,000, and it is therefore assumed that the salvage recovery was credited to the reserve. But this recovery represented a provision of funds, and hence entry K is made to set the $5,000 out as a separate item to be carried to the funds-provided column.

(L) Expenditures for renewals and replacements of plant in the amount of $10,716.43 were recorded by charge to the depreciation reserve. These expenditures involved an application of funds; hence entry L is made, completing the analysis of the reserve account and setting the $10,716.43 item out separately to be carried to the funds-applied column.

(M) The payment of the 1920 federal tax assessment required an application of funds, and this is indicated by entry M crediting the reserve for contingencies and setting the payment out as a separate item to be carried to the funds-applied column.

(N) The appropriation of $100,000 from surplus to the reserve for contingencies was a non-fund entry, and hence is reversed. Entries M and N dispose of the change in the balance of the reserve for contingencies, by analyzing it into its elements, one of which constitutes an application of funds, and the other a factor in the analysis of surplus.

(O) The charge of $1,200 made against the pension-fund reserve presumably records pension payments, which are set out separately by entry O as a fund applied.

(P) But since the pension-fund-reserve account has increased $881.50 during the year in spite of the $1,200 charge, it appears that a credit of

$2,081.50 was made in the account by charge to profits and eventually to surplus. But such credits to reserves do not involve funds, and hence the appropriation to the reserve is reversed by entry P.

(Q) The charge of $4,560.90 to the dredging reserve presumably records an expenditure, which is set out by entry Q as a fund applied, and

(R) To account for the present balance in the dredging reserve it is necessary to assume an appropriation of $4,950.49 out of profits, which, being a non-fund entry, is reversed.

(S) The common-stock dividend of $400,000 changed the balances of the stock and surplus accounts without involving funds, and hence entry S is made to reverse the one recording the stock dividend.

(T) Surplus has been charged during the year with $14,680.75 in respect of cash dividends on preferred stock, this amount being the total of the four amounts shown in the problem as having been declared during 1924. As dividends involve an application of funds, entry T is made to set them out separately as a fund applied, and to continue the analysis of surplus.

(U) This entry is similar to T except that it applies to common dividends.

Consideration has now been given to all the facts stated in the problem as indicating adjustments. The analysis of surplus, however, is not complete, as the items entered in the two surplus-analysis columns do not account completely for the change in the surplus balance. The two surplus-analysis columns are brought into balance by inserting $891,091.92 as the amount of funds provided by profits, and this amount is carried to the funds-provided column.

The adjustment columns are then footed to determine their equality as evidencing the correctness of the entries made therein; the amounts shown in the year's-excess debit and credit columns plus or minus amounts in the adjustment columns, are then carried to the appropriate working-capital or funds columns. The increase in working capital is entered as a balancing figure in the working-capital-decrease column, and carried to the funds-applied column, and the working-capital and funds columns are footed. The working papers are now complete.

Funds are provided by the profits of the year, but the net profits, as shown by the profit-and-loss statement, and the funds provided by profits, as shown by the statement of application of funds, are usually different amounts because certain charges, such as depreciation and amortization of bond discount, have been made against profit and loss which reduced the profits without reducing the funds provided by the profits. It is customary to prepare the statement of application of funds in such a way as to tie up the net profits as shown in the profit-and-loss statement with the funds provided by profits as shown in the statement of application of funds. This is done by setting down the net profits and adding the non-fund-requiring charges to profit and loss, the total being the amount of funds provided by profits.

But this problem does not state the amount of net profit shown by the profit-and-loss statement, and hence it is necessary to determine it if the usual tie-up mentioned above is to be shown. The net profit can be determined by the following tabulation of the figures shown in the surplus analysis of the working papers:

		Profit and loss Debit	*Profit and loss* Credit	*Surplus* Debit	*Surplus* Credit
Bond discount amortized		$4,000.00			
Worthless investments written off		10,000.00			
Depreciation:					
Credit to reserve	$132,716.90				
Less realized appreciation	17,126.50				
Net charge to profit and loss		115,590.40			
Appropriations to reserves:					
Contingencies				$100,000.00	
Pensions		2,081.50			
Dredging		4,950.49			
Capital-stock dividend				400,000.00	
Cash dividends declared:					
On preferred stock				14,680.75	
On common stock				280,000.00	
Total debits to surplus				$794,680.75	
Net decrease in surplus				40,211.22	
Credit to surplus—net profit transferred from profit and loss		754,469.53		$754,469.53	
Funds provided by profits		$891,091.92			

From the foregoing data the following statements called for by the problem can be prepared. The problem does not specifically call for a schedule of working capital, but this is usually assumed to be required as supporting the statement of application of funds.

X Y Z Company

Statement of application of funds, year ended December 31, 1924

Funds provided:

By profits:			
Net profit for the year—per profit-and-loss statement		$754,469.53	
Add charges to profit and loss which reduced the profits without reducing the funds provided by the profits:			
Credits to reserves:			
Depreciation	$115,590.40		
Pensions	2,081.50		
Dredging	4,950.49		
Bond discount amortized	4,000.00		
Worthless investments written off	10,000.00		
		136,622.39	
			$891,091.92

By issue of ten-year 6% gold bonds:		
Par value	$500,000.00	
Less discount	40,000.00	
		$460,000.00
By issue of preferred capital stock		62,300.00
By sales of investments in securities:		
Book value	$70,000.00	
Less loss	50,000.00	
		20,000.00
By sale of salvage from brick storehouse		5,000.00
Total funds provided		$1,438,391.92

Funds applied:

To expenditures for fixed assets:		
Additions and improvements	$520,989.81	
Renewals and replacements	10,716.43	
		$531,706.24
To expenditures for investments in other companies:		
Affiliated	$25,000.00	
Outside	60,920.40	
		85,920.40
To cash dividends:		
On preferred stock	$14,680.75	
On common stock	280,000.00	
		294,680.75
To payment of federal tax assessment for 1920		47,738.95
To increase in working capital, per schedule		454,362.03
To miscellaneous expenditures:		
Pensions	1,200.00	
Dredging	4,560.90	
Deferred charges	18,222.65	
		23,983.55
Total funds applied		$1,438,391.92

X Y Z COMPANY

Schedule of working capital, December 31, 1923 and 1924, and comparison

	December 31,		Changes in working capital	
	1923	1924	Increase	Decrease
Current assets:				
Cash	$152,928.16	$221,314.90	$68,386.74	
Notes receivable	41,368.00	85,618.20	44,250.20	
Accounts receivable —net	249,628.30	378,920.62	129,292.32	

	December 31, 1923	December 31, 1924	Changes in working capital Increase	Changes in working capital Decrease
Due from affiliated companies.....	$116,283.25	$146,962.18	$30,678.93	
Inventories........	896,762.80	950,319.60	53,556.80	
Total...........	$1,456,970.51	$1,783,135.50		
Current liabilities:				
Accounts payable...	$215,962.10	$127,824.11	88,137.99	
Notes payable......	230,000.00	170,000.00	60,000.00	
Dividends payable..	68,048.50	79,138.75		$11,090.25
Accrued interest, taxes, etc......	87,368.20	96,218.90		8,850.70
Total...........	$601,378.80	$473,181.76		
Working capital......	$855,591.71	$1,309,953.74		
Increase in working capital........				454,362.03
			$474,302.98	$474,302.98

Book Reviews

HARVARD BUSINESS REPORTS, VOLUME I, compiled by the Graduate School of Business Administration, Harvard University. *A. W. Shaw Company*, Chicago. Cloth, 561 pp.

"In this volume are published 149 cases selected from the file of business cases collected by the Harvard graduate school of business administration through its bureau of business research, and with the coöperation of its faculty. Each case has been judged to have significance, either as a record of current business practice or as a guide to sound business management. The decision stated in each case is that reached by the business firm; in no instance has the school or the bureau undertaken to inject editorial opinion."

So states the first paragraph of the foreword of *Harvard Business Reports*. The cases published in this volume cover a variety of problems involving matters of accounting principle, mathematical computations and questions of business policy. Examples of the subjects covered, taken at random, are as follows: Investment of capital in foreign plant; cost accounting for differential wages; wording of letter concerning re-employment; use of temporary surplus funds; economies of consolidation; budgetary control of expenditures for capital account; fixation of piece rates; redemption provision in new bond issue; standard costing rates for by-products; centralized organization, and purchase and sale of municipal bonds.

It is important to note that the decisions in each case may or may not be concurred in by the school, and therein lies the value of the book as a basis for classroom debate.

It would seem that the volume under review and those which it is stated are to follow, though primarily intended for school use, might well be used to good advantage by public accountants in questioning applicants for staff positions, and they should find a place in the library of the wide-awake business executive who is anxious to learn what others have done when confronted by perplexing situations.

The school is to be congratulated on a substantial piece of work well done.

EDWARD H. MOERAN.

INCOME-TAX PROCEDURE, 1926, AND EXCESS-PROFITS, ESTATE, GIFT, CAPITAL-STOCK-TAX PROCEDURE, 1926, by ROBERT H. MONTGOMERY. *The Ronald Press Co.*, New York.

A review of Mr. Montgomery's annual contribution upon the subject of federal taxation seems entirely superfluous if the reviewer is expected briefly to comment on its contents. This year's contribution is in two volumes. They contain, as usual, the law, regulations, interpretations, court decisions, board of tax appeals decisions, and what is most helpful, the author's own comments and elucidations of the numerous phases of the law. If one is interested in having the latest information upon any given tax subject, he will find it in these books, indexed in such a manner as to make it readily accessible.

The author justifies his "temerity" in publishing the 1926 edition of this work just prior to the enactment of the new law, by reasons that seem unnecessary and inadequate. He states them to be that the arduous and faithful labor of his associates would have been rendered partly futile if the work were not published, and that the 1926 act will not differ essentially from the former acts.

It would seem that the most important reason for the publication of the book at this time is that Montgomery's books upon federal taxation are invaluable aids to taxpayers who are called upon to explain and defend the tax returns they have made in past years.

Often a taxpayer receives one of the famous notices from the commissioner, gently intimating that upon some astute examining officer's discovery, however painful it may be, he is contemplating an assessment of an additional tax for some past year. After the first impulse to sit right down and tell the commissioner how grossly he is in error has passed, the suffering one seeks some authentic source such as Montgomery's tax annuals for information upon all phases of the question at issue.

From such considerations, one comes to the conclusion that it is fortunate that books upon 1926 tax procedure are made available even though the new law is not yet enacted. If the new law is ambiguous in any particulars (and it probably will be if history is to be relied upon) it will be a long time before the exact intent and meaning of these ambiguous passages will be elucidated. It has taken eight years to discover that taxpayers keeping their books upon an accrual basis are not entitled to report taxable income on the instalment basis for such sales as are made by them on the instalment basis, and it is not yet certain that the "discovery" is authentic. It has taken nine years to find out that income taxes accrue in the year in which the transactions occur upon which they are computed. This, too, is not definitely decided.

STEPHEN G. RUSK.

AN INTRODUCTION TO THE METHODS OF ECONOMIC STATISTICS, by WILLIAM LEONARD CRUM and ALSON CURRIE PATON. *A. W. Shaw Company*, Chicago and New York. 493 pp.

An Introduction to the Methods of Economic Statistics fulfills the main purpose for which it was compiled. The text, while technical and calling for a knowledge of mathematics of a high order on the part of the reader, is primarily adapted to the needs of the statistical student and the practitioner who should find it helpful in their studies and work. It covers in thorough fashion the treatment of groups of numerical data from their origin through the course of their refinement for use in statistical determinations, so much relied upon nowadays for the interpretation of past economic experience and for estimating the probable experience of the future. The importance of any plan or procedure which lends effective aid in future determinations based upon available knowledge of past economic facts is admitted by nearly every one.

The requirements of the student are borne in mind in the introduction to the subject contained in the various chapters of part I, particularly those relating to the collection of primary data, the compilation of secondary data and also the construction of tables and charts. The significance of the reliability of sources and the accuracy of compilation of data obtained therefrom to the finished tabulated or graphical product has received due stress by the authors.

The science of statistical presentation is extended in part II in the discussion of analytical methods for the summarization and interpretation of statistical data. In part II is presented the application of these methods to the important subject of price changes, wherein the determination of price relatives and index numbers and the bearing thereon of the influences of time fluctuations receive careful exposition.

The high value of intelligent study and sound presentation of economic data (even the term phenomena may here be used) is obvious in this day of economic activity. The glass through which such data may be seen more clearly is provided by such treatment as is advanced in this important addition to statistical literature.

G. K. Hyslop.

COST ACCOUNTING PRINCIPLES AND PRACTICE, by J. P. Jordan and Gould L. Harris. *The Ronald Press Company*, New York. Cloth, 562 pp., with chart.

This is the second edition, revised and enlarged, of a classroom text first published in 1920. It is a very comprehensive study of the principles and practice of cost accounting; indeed, but for the flood of cost-accounting literature of the past few years it might almost be called the last word. That, however, would now be a rash statement. The field is so broad and the interest aroused by the Hoover campaign against waste so great that one can not yet say that the whole field has been covered. The authors themselves rather significantly point out that the costs of the selling department have barely been touched upon so far.

It is worth while to note the happy combination of practice and theory represented by the authors of this work. Mr. Jordan as a consulting management engineer, member of the American Society of Mechanical Engineers and formerly president of the National Association of Cost Accountants, brings into play his practical experience, while Mr. Harris, as assistant professor of management in the school of commerce, New York University, undoubtedly has had much to do with the arrangement of the book to make it a lucid and consecutive text for the student. It is needless to say that both names are a guarantee for honest and careful treatment.

Students of cost accounting, not only college students but also accountants who are realizing the growing importance of cost-accounting knowledge in auditing practice, who look for a mechanical short-cut to procedure in this book will be disappointed. The aim of the authors has been to set forth the basic principles upon which all plans of cost accounting must be founded. They attain their object by a well planned treatment which follows the flow of cost procedure in a logical and connected sequence of operations (chapters I to XXVIII) which must be studied in connection with the large chart of operations in the back of the book. The other chapters deal with special points not a part of the regular procedure but necessary nevertheless to a complete understanding of the subject. It is not a book for casual reading. It most emphatically requires study, and hard study, but it will amply repay the man who wants to know what cost accounting is and what it may be. No doubt the criticism will be made that we have here a broad and complicated procedure applicable only to very large manufacturing concerns, a procedure that the average public accountant will not encounter in his whole professional life. True, but such criticism misses the point. It is only by studying and assimilating such complicated procedure that we can acquire knowledge of the basic principles. Once these are grasped they may be applied to any concern, large or small.

The whole book is so evenly compiled and dovetailed, as it were, that it is difficult for a reviewer to pick out salient points either for praise or for criticism. Perhaps the most important chapter is that which emphasizes the necessity of starting with proper bases of costs—the fifth chapter. Failure in this respect was no doubt the cause of much wasted time and effort in the past, and gave a black eye to cost accounting in its earlier days. A close second is chapter III advocating departmentalization of the plant and accounts for closer analyzing costs and finding weaknesses. The prime object of cost accounting is control, and it is only by planning the system on these two bases, proper units and logical departments, that such control may be exercised by the management.

As would be expected in a classroom text, some fifty pages are devoted to questions on each chapter, including a long general problem in cost accounting by Henry Heaton Bailey, assistant professor of accounting, University of Illinois. These questions are such as might well be asked in any C. P. A. examination and furnish good laboratory work for the student, especially the general problem which covers practically all that is taught in the book.

There may be details which seem over-refined to the practitioner. For example, since cashbooks and voucher registers are journals in fact, it may appear a waste of time and labor to formulate summaries of these and enter them in the general journal. But these are optional matters which the accountant may treat as he finds most convenient.

Interest as cost bobs up as might be expected! After explaining how and where it may be useful in determining actual costs, the authors leave it to the practitioner to decide for himself. Perhaps the reviewer ought also to pass it over, but when the authors recommend charging interest to cost: "1. On buildings and real estate, in order to equalize the property occupancy cost with competitors who pay rent" (p. 456), the reviewer is moved to ask, "Why?" By the same reasoning the manufacturer whose raw materials lie at his door should charge "theoretical freight" to cost in order to equalize his materials cost with competitors a thousand miles away from their source of supplies!

W. H. Lawton.

ANALYSIS OF RAILROAD OPERATIONS, by Joseph L. White. *Simmons-Boardman Publishing Co.*, New York. Leatherette, 381 pp.

The purpose of *Analysis of Railroad Operations*, best stated in the language of the author in the introductory paragraph, page 1,

> " . . . is to review the system of accounts and statistics established on the railroads of the United States by the interstate commerce commission, and to outline the methods by which these accounts and statistics may be used to analyze the activities of a railroad and the results obtained from its operations."

From this it will appear that the book is of interest to a rather limited class of readers, mainly those who are interested in railroad securities. It should be valuable also to university classes in higher accounting as a study in proper methods of analyzing accounts and statistics in general, for those laid down and explained by the author are adaptable to almost any field of operations. Above all it would be an admirable manual for members of congress and state legislatures—but that would be too much to expect!

The author's methods are clear and explicit. He tells the reader what information should be sought from the data furnished in the voluminous reports of railroad operations, and how it is to be obtained. It is a timely book, for with railroads limited as to their income they must seek ways of reducing expenses, and as the government is now interested in any excess profits it is right that the public should have some means of detecting unwarranted increases in expenses.

A good half of the book is made up of appendices containing abstracts, classifications and orders of the interstate commerce commission, all quite necessary to a complete understanding of the main text. A good index facilitates references.

W. H. Lawton.

Current Literature

Compiled in the Library of the American Institute of Accountants

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