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The JOURNAL of ACCOUNTANCY

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NOVEMBER, 1925

NUMBER 5

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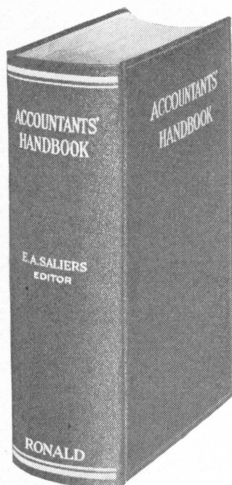
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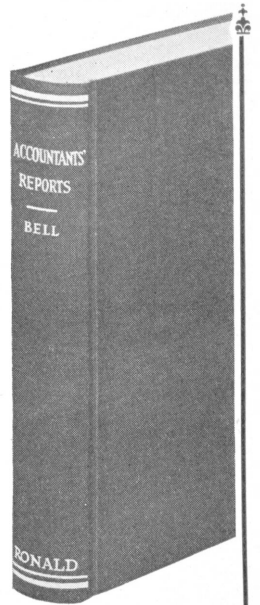
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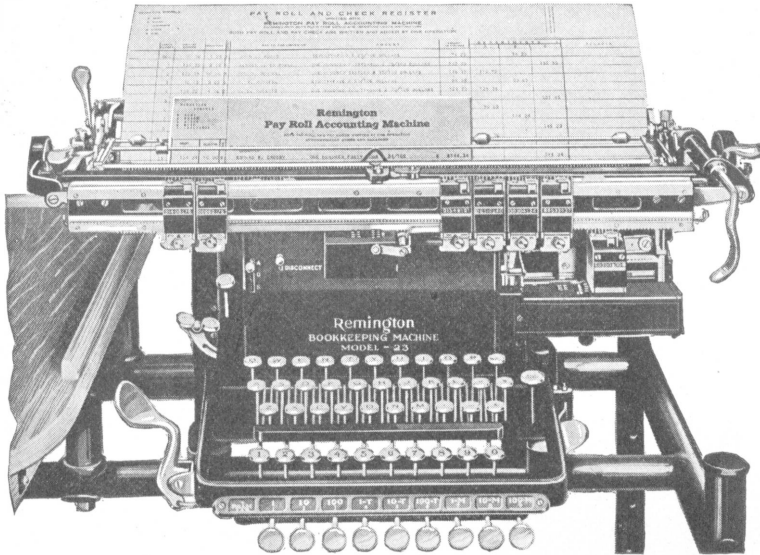


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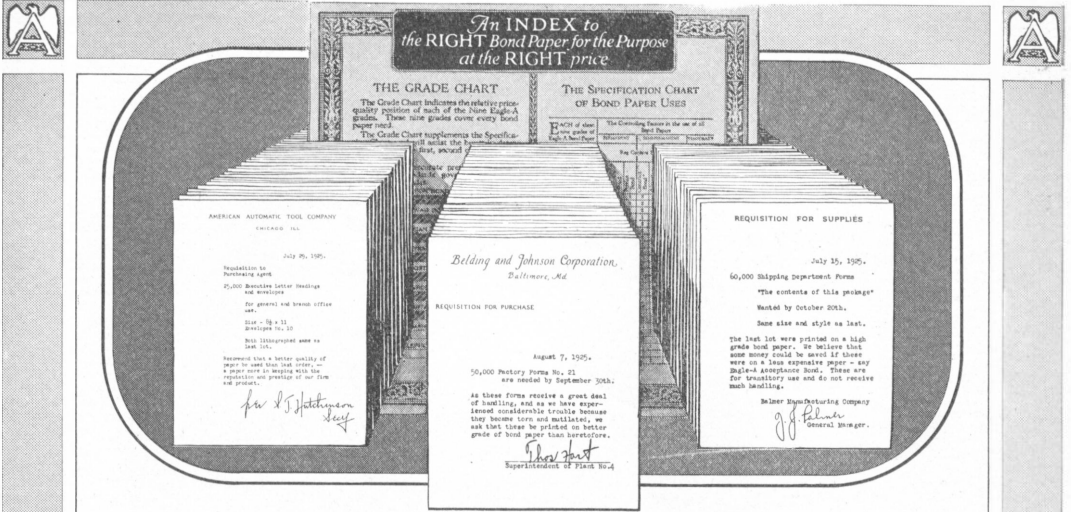
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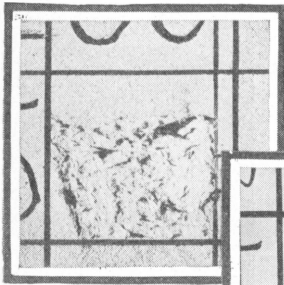
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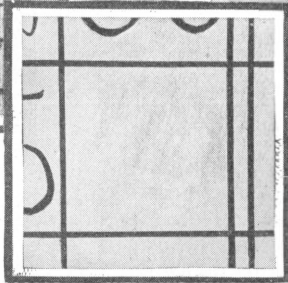
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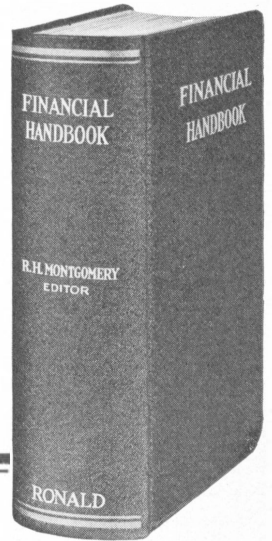
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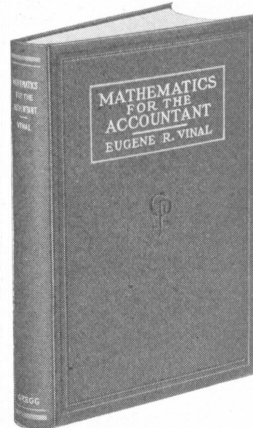
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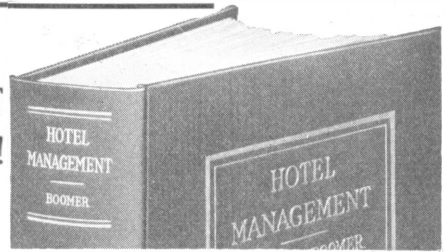
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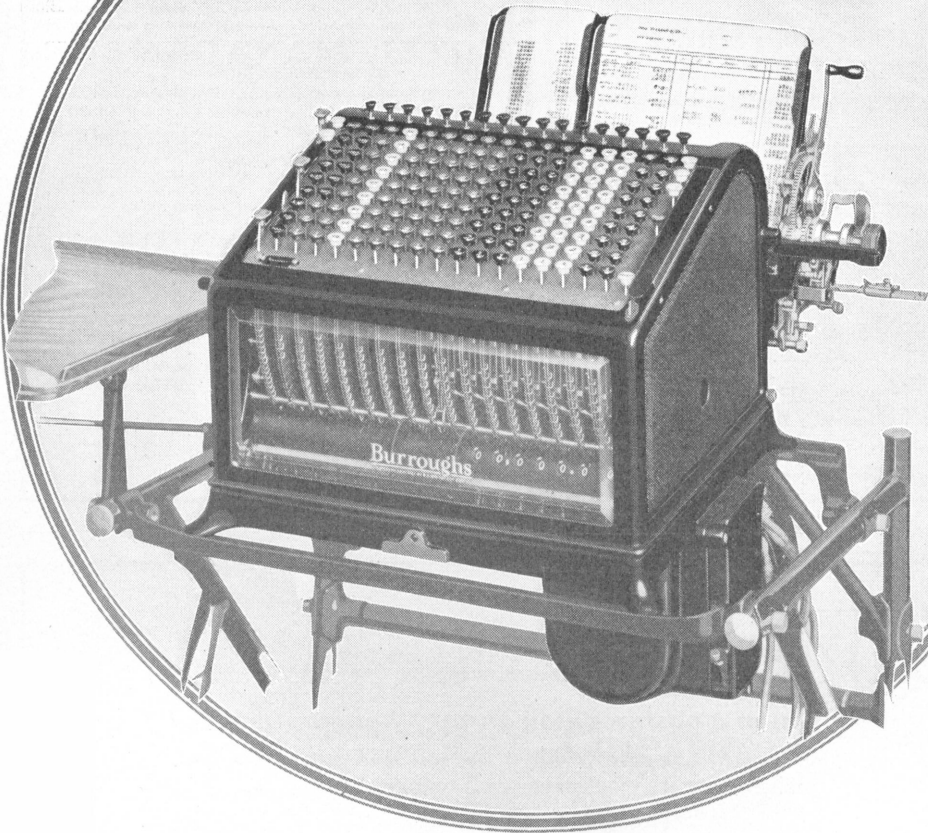
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The Board of Tax Appeals and the Certified Public Accountants*

BY J. GILMER KORNER, JR.

For three years next preceding the creation of the board of tax appeals I was connected with the office of the solicitor of internal revenue, and during that time I made the acquaintance of your profession and worked more or less with you. The advent of the board of tax appeals continued that acquaintanceship and at the same time created a new relationship between us. It is concerning this new relationship that I desire to talk with you this afternoon.

The policy with respect to the admission of certified public accountants to practise before the board of tax appeals was adopted after careful consideration. I was one of the original appointees of the board and took part in that consideration and in the adoption of that policy. Neither I nor any member of the board has had occasion to regret the action taken. The certified public accountants of our country have met this new situation in a manner which merits the admiration and respect of all who have observed it. What I have to say, then, should not be taken to be a criticism of your work before the board, nor as an indication that the board feels that its policy just referred to was not a wise one. Neither is true. Furthermore I do not wish to be understood as holding a brief for my own profession in the matter of practice before the board. This is equally far from my thoughts.

During the course of my membership on the board, I have on frequent occasions had members of your profession ask me how and in what way a certified public accountant can best serve the

* An address before the New York State Society of Certified Public Accountants, New York, October 14, 1925.

interest of his client in handling an appeal before the board. Such a question covers too much territory for me to answer even if I felt able to do so. However, this question has been the subject of a great deal of discussion among the members of your profession and on many occasions I have discussed it with them. There appears to me to be a feeling among many who stand high in your profession, and in the councils of your societies, that there is a danger of your extending the sphere of your professional practice into a field where it cannot do full justice to itself and that thereby the welfare of the client is in possible danger of being jeopardized.

Those discussions have been of a character most frank and earnest and I am impressed that there are many among you who entertain some real concern along this line. Not being a member of your profession I do not feel at all qualified to offer any advice and it is not my intent to do so. At the same time I have been impressed with the seriousness of the thought given to this subject by those of you who have so frankly discussed it, and at their suggestion I have undertaken to outline briefly a few observations that have been evolved in these discussions.

As a premise I may lay down the proposition that the client's interest is your first concern. All other considerations should be subordinated to that. As I view it there are two parallel courses leading to this ultimately desired end. These two courses are not divergent but convergent. To this extent they are not precisely parallel but do go hand in hand. One is the compilation, analysis, and marshalling of all the facts constituting the whole truth of the taxpayer's case. The other is the presentation of these facts in orderly and logical array, under certain prescribed rules of practice, to the tribunal hearing them. This latter constitutes advocacy. Each of these duties requires a particular and special training. But to my mind there is a more fundamental difference than merely that of training.

If I understand aright it is the duty and aim of your profession to ascertain every fact and every truth bearing on the tax liability of a client—irrespective of whether or not such facts and truths are favorable or unfavorable to his own contention. I am advised that the ethics of your profession demand that every fact be exposed and that none be concealed, and that your profession stands back of the work of each member who observes these ethics, as a guarantee of the fairness and accuracy of the

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profession. No higher standard could be set for any profession than this. The aim of such an exalted standard is of course to invite and command the confidence and respect of all men in the work of every certified public accountant. Such a consummation is devoutly to be wished and any act or thing which would tend to blunt or even slightly to dull this fine edge of confidence and respect should not be lightly undertaken.

Now on the other hand, the duty imposed upon an advocate is different. His is the duty to see that his client's case is fairly and accurately presented in its favorable aspects, leaving to his opponent the duty of detecting and exposing its weaknesses and of presenting in a similar manner the favorable aspects of his side of the case. So long as an advocate does not resort to deceit, unfairness or treachery, his duty is accomplished when he has presented his client's case as above outlined, and in so doing he has practised within the ethics of his profession. No invidious comparison can be made as between the two codes of ethics. Each profession has a different function to perform and the faithful and honest performance of that function fulfills the requirements and the ethics of that profession.

The apprehension, which has been expressed to me by prominent members of your profession, is that the certified public accountant by becoming an advocate will of necessity feel constrained to adopt the practice and the ethics of the advocate and in that process lose sight of the obligations and ethics of his own profession to which I have just alluded. The question is, Can any man fill two capacities with separate and distinct requirements and do justice to himself and his client in both? With the corollary query, can he, under these conditions, do justice to both professions which for the time being at least he represents? The apprehensions are not, as I gather it, due to solicitude for the standard of the profession of advocacy but for the maintenance of that severe ideal sought for the profession of accountancy.

By reason of the high standard of ethics that your profession has set for itself, it has established such a reputation for accuracy, probity and full disclosure of all facts, that the certified statement of one of your members is relied upon and accepted without reservation by bankers and other extenders of credit. This is evidence not merely of an ideal, of something to strive for, but of an actual accomplishment, a goal reached. It is jealousy of this confidence and respect, this accomplishment, which is causing the

apprehension of some of your members to which I referred a while ago.

I have often heard the jocular inquiry as to which has the better chance of success—a good case poorly presented or a poor case ably and skilfully presented. I do not know the answer. On the whole, perhaps it is an even break. I can say this, however: There may be an excuse for the latter but there can be nothing but regret and disappointment growing out of the former. The board of tax appeals has had the experience of hearing all kinds. There have been good cases well presented, good cases poorly presented, poor cases well presented and poor cases poorly presented. Whether the board has been able to find the right answer in all of them is a matter on which I do not here express an opinion. If it has not done so in the first situation it is the fault of the board. As to the other three, the board has at least a defensible ground for failure. You will note that of the four given, there is only one in which the board has the full opportunity to do justice to itself. It may do justice to the parties even in the other three but it is at the expense of great labor and even uncertainty, at best.

And now, aside for a moment from the consideration of any effect on the standards of the profession of accountancy which may be involved in certified accountants acting as advocates, let us consider the case purely from the standpoint of the taxpayer. He is your client and to him, of course, is your first duty. To see that your client gets exact justice is your aim. He goes to you because you are a specialist in the complicated economic structure within which we live. He goes to you for the further reason that he has confidence in your skill and attainments to tell him with exactness what taxes he should pay. Assuming he is an honest client, you advise him fully of his liability and show him all the details—the details which work in his favor as well as those which do not. If he is not an honest client and you are not able to satisfy yourself that you know the truth and the whole truth, you would of course decline his case. Having fully satisfied yourself of the true condition of your client's liability and so advised him, what is your next duty? It is to present it to the tribunal designated to hear it. If you are not fully equipped for that duty, then no matter how carefully and accurately you have prepared his case, the client is in danger of sustaining a loss of his appeal. It is just here that I feel the certified public account-

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ant should carefully weigh in his mind his responsibility to his client.

I have been told by some certified public accountants that since the organization of the board of tax appeals, they feel the need of the study of the law of evidence, and that they intend to enroll in a law school and take special courses in pleading and evidence. That is all right as far as it goes, but I fear that it does not go far enough. A knowledge of pleading and evidence is very helpful, but a mastery of them is difficult and comes only with long experience and practice. There are men who are native advocates, who by instinct have the flair of advocacy. But, as I view it, there is a more fundamental necessity in the presentation, argument and briefing of a case. Let us advert again to the point where you are weighing in your mind your responsibility to your client. If his case, in addition to the facts of accountancy of which you have the mastery, involves the interpretation of a contract under a statute or the common law of a given state, or perhaps involves the even more difficult problem of real property, your knowledge of pleadings and evidence would perhaps not serve to protect your client's rights.

The experience of the board shows that comparatively few appeals involve issues of pure accountancy. By that I mean issues in which no questions of substantive law are presented. Well-nigh every appeal involves such law questions and these run the whole gamut of law—corporations, trusts, domestic relations, banking, torts, partnerships, contracts, real property, negotiable instruments, receivership and bankruptcy, and even criminal law in cases in which fraud is involved. Each and every one of these enumerated branches of the law has been presented to the board not once but repeatedly. Any advocate who is not thoroughly grounded in these subjects is at a grave disadvantage in presenting cases in which they are involved. You can see from this, that a superficial or even a thorough training and understanding in pleadings and evidence would not enable you to do justice to yourself, your profession or your client.

As I stated at the outset, what I have said here is not in criticism nor is it intended in a spirit of gratuitous advice. That is neither my province nor my intent. But, I am interested in the success of the board of tax appeals. I am anxious beyond measure for it to fulfill in every possible way the functions for

which it was created. I want to see its decisions respected for their merit and justice. The care and accuracy with which a case is prepared contributes immensely to the ability of the board to render such decisions, and the same is true of the clarity and skill with which it is presented. It is therefore of great interest to me to see cases both well prepared and well presented. As I said a while ago, each requires a special kind of training. There is ample room and reason for men of both classes of training to work together for the desired end, viz.; the better trial of tax cases.

Of late I have talked with the heads of accounting firms and also of law firms and I am struck with the similarity of the realization brought home to both, viz.; that in the preparation and trial of tax cases both are at a grave disadvantage without the help of the other. Only a short time ago the head of one of the largest law firms engaged in the tax practice said to me that his firm had long since realized the absolute necessity of associating with themselves certified public accountants in the preparation and presentation of every tax case in which they are employed. He said that the first advice given by his firm to a client is that such an accountant should be employed. If the client does not want to do this, the firm does it on its own responsibility. He then called my attention to the success which his firm enjoyed in the practice both before the board and in the bureau of internal revenue and stated that he attributed such success largely to this policy. On the other hand, I have had conversations with certified public accountants, both individual practitioners and members of prominent accounting firms, and they have stated in almost exactly the same language that their experience had taught them the necessity of associating legal counsel in tax cases before the board, as well as in the bureau of internal revenue. One of them remarked to me that he had come to believe that nothing could present a more helpless picture than a certified public accountant attempting to present a real tax case without the assistance of a lawyer, or a lawyer attempting to present a tax case which he had attempted to prepare without the advice and assistance of a certified public accountant.

Personally, I feel that these two important professions are of necessity complement to each other in the tax practice. I have seen the combination work so satisfactorily to both professions and to the board (and, I might add, to the client as well) that I

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am reminded to quote from Hiawatha (without fully adopting the ultimate conclusion):

“As unto the bow the cord is,
So unto the man is woman:
Though she bends him, she obeys him,
Though she draws him, yet she follows,
Useless each without the other!”

And now let me take a few minutes more of your time and turn to the matter of what the board is doing. As you know, the board was organized on July 16, 1924. The first case was heard about the middle of August of that year. However, it was approximately the middle of October before we began hearing cases with any degree of regularity because of the few cases coming to issue in the formative stages of our existence. It was not until about the first of this year that the board really took its stride. There were twelve members of the board until April 1st of this year, at which time four new appointees took office. The resignation of one member at that time made the board membership fifteen. This number remained constant until September 1st, when one new member took office. A week later, however, another member resigned, so that the number remains at fifteen.

Since our organization and until October 1st of this year, 7,664 appeals have been filed. Of this number, to the same date, approximately 3,000 have been heard and disposed of. This is almost fifty per cent. As I said a while ago, the board did not begin at once the hearing of cases after its organization. A vacation period of approximately six weeks was observed from the middle of July to the first of September of this year, so that the work indicated above covers approximately $9\frac{1}{2}$ months of activities, or about 400 cases a month. It has not been easy to accomplish this amount of work and it has been possible only by dint of the utmost exertion and industry on the part of the members as well as of the entire personnel of the board.

The board is calendaring appeals for hearing approximately four months from the date of issue and is hearing and disposing of them as they come on for hearing. In view of the intricacy of the problems presented and the care and thought required in their solution, this is perhaps not an unreasonable period in which to reach appeals after their coming to issue. When a case can be heard approximately four months from the date of issue, it is in a real sense current—or practically so. Our experience shows

that the average taxpayers, indeed most taxpayers, desire a period of from four to five months in which to prepare for trial. And even at that there are numerous delays brought about by continuances requested by taxpayers. Many appeals could be, and would be, reached sooner if the parties were at all times ready to go forward.

There have come to my attention lately stories and rumors to the effect that the board is four or five years behind in the hearing of its calendar, and that to date approximately 600 cases out of over 7,000 have been disposed of. From what source this misinformation originates, I do not know. All of the records of the board are open to the public and there would seem to be no reason for inaccurate and misleading statements to become current when exact information is so readily obtainable.

You may be further interested in the work of the board from the standpoint of dollars. Some time ago I caused a compilation to be made of 1,500 appeals. These were not picked cases but were taken bodily from the files in accordance with their docket numbers—the run of the mine, so to speak. A review of these appeals shows that the average deficiency per appeal is \$15,264. On this basis the total number of appeals filed to October 1, 1925 (7,664 in number), involve deficiencies of \$116,983,296. And on the same basis the appeals heard and disposed of involve \$58,000,000. As I said before this represents approximately 9½ month's work or an approximate average of \$6,000,000 a month.

The board and every member of it are conscious of the magnitude of the task in hand. The income-tax law is necessarily intricate because of its breadth of scope and universality of its application to a wide diversity of subjects and persons. The problems it presents are many and difficult of solution. The board is striving hard to solve these problems correctly but it need not be said that to do so it must have the assistance of a high degree of technical skill. This assistance the certified public accountants are able to give us. With the quality of assistance, which a profession with such exalted and severe standards as yours can give us, our task will be made easier and the complex problems of taxation may be brought to a more exact science, to the satisfaction of all the taxpayers of our country and to the government of which they are a part.

Investments

BY F. W. THORNTON

Some recent writers have pointed out misapprehensions as to the relative position of bonds and stocks as investments. They have done much to clear the public mind, although much remains to be said. It is intended to show here something of the variation among differing classes of common stocks, and for that purpose a short review of the whole situation, covering bonds as well as stocks, seems needed.

Perhaps accountants are about as well fitted as anyone to point out popular gross accounting errors in matters of investment. Should the question be asked: What are the safest forms of long-term investment? the answer would almost surely be: life insurance, good bonds and mortgages, savings bank deposits, good preferred stocks, good common stocks—and about in that order. Accountants are not a little responsible for this general classification of investments. Figures for the last twenty years show that the order should be reversed.

Consider first the position of the bonds. If a person in 1913 had bought a gilt-edged bond, say, U. S. Steel sinking fund 5%, he would have received in interest \$600, which, with return of the capital, would amount to \$1,600. How much better off is a man with \$1,600 in 1925 than he would have been with \$1,000 in 1913? What was the real income available to buy things to eat and wear?

Fortunately, there are available figures to show this. So-called "index figures" showing the cost of all commodities and of the cost of living as compared with 1913 are published by Harvard university, Fisher, Bradstreet, bureau of labor statistics, and others. All concur in a figure for 1925 indicating the costs as compared with 1913 to be about 155 per cent. This means that \$1,550 would buy of general commodities as much as \$1,000 would have bought in 1913. Our bondholder has received in twelve years \$50 of income in excess of that needed to preserve the value in necessities of his original \$1,000.

Suppose the money had been put in the savings bank at 4% interest. Compounding the interest his present deposit would be almost exactly \$1,600. Again the real return is \$50 in twelve years:

Our investor might well have wrapped his talent in a napkin—bought steel rails, washing soda, window glass, anything—and stored it in his cellar till now; he would be about as well off.

In time of severe stress, such as Europe has been passing through since 1918, the case is worse. An instance cited to me was that of an Hungarian family with an income from industrial bonds—I think it was 5,000 kröner—sufficient to enable them to get enough to eat and wear and to maintain a certain gentility albeit a little shabby. Since the war their coupons are sufficient to buy a small sandwich once a year.

True, they would have lost had their investment been in the stock of the company whose bonds they held; but not nearly so severely, for the stock represented some assets which remain and are not the sport of debased currency nor subject to the steady loss of value that all currencies have suffered in all countries at all times ever since the laborer got one penny, his full union rate of hire for a day's work in the vineyard. Who can point to a case of increased purchasing power of a monetary unit over a period of 100 years? I have sought it in vain.

He who buys a bond or mortgage, life insurance, non-participating preferred stock, or acquires in any way a future right to a specified amount of money is gambling on the chance that a money unit, gold or other, will retain its purchasing power—a losing bet for a thousand years.

But, suppose our investor had put his money into good common stock—to continue the parallel let it be U. S. Steel common, although any good stock would do. First, his immediate return would have increased from \$5 to \$7 a share annually; not enough, truly, to compensate for the increased cost of living, but an increase. Next, his stock is still represented by assets (aside from profits retained in the business) that would be worth as much, measured in the world's goods, as those that represented it in 1913. And, finally, it is probably represented by two additions, one being the undistributed profits and the other the amount represented by the loss in real value of the bonds and preferred stock arising from the fact that they with their interest and dividends are repayable in a less valuable monetary unit.

If a steel furnace costing \$200,000 in 1913 were then bonded for \$100,000, the bondholders would own half of it and the stockholders would own the other half. If it were now replaced, as such furnaces often are, and were constructed no worse and no

better than before its cost would be perhaps \$400,000. Now our bondholder owns one quarter of it, the stockholder three quarters.

It is true that common stocks fluctuate in price much more than bonds, but it is equally true that over any long period the net effect of all the fluctuations of common stocks is a rise in money value more than equal to the rise in the index figure for general commodities.

It is also true that common stocks sometimes become worthless. The remedy is to spread an investment over many stocks. Upon the whole the gain on those that do not fail is more than enough to compensate for loss on those that do, provided that the stocks are chosen with a moderate amount of judgment.

Bonds are not altogether free from losses. Whenever such losses occur in the case of trustees' investments there is no compensating gain on other bonds, such as has been spoken of in the case of common stocks; the principal of the trust is irremediably depleted, even on the dollar basis. At the present time we have some bonds that either are or have been considered gilt-edged, to which attention might be directed—What price Chicago, Milwaukee & St. Paul 4%, Erie 4%, New York Railways 6%, Chicago & Northwestern 3½%?

A danger to which investors in common stocks are subject is the temptation to sell when a profit appears, in short, to speculate. It is pretty well resisted by the owners of large fortunes. Every accountant knows that the really wealthy choose their common stocks carefully and keep them long; that they are not affected by the daily fluctuations in price but hold their stocks with a view to development over many years. That is the difference between investment and speculation.

Looking broadly at the investment situation as it affects trustees, the prescribed investments under the laws governing trusts are such as to insure with all but absolute certainty the eventual realization by the beneficiary of a sum not greater in dollars and less in purchasing power than the sum originally deposited in the trust.

Let it be admitted that the instances cited are extreme—they are. War conditions have hurried forward the rising tide of prices, and for a few years we may look for a period of relatively slow loss of purchasing power of monetary units. None the less these instances, while exaggerated, are highly characteristic of the whole financial history.

Not everyone is fooled. Our financiers know better than to bury their money in bonds. They know that falling money values favor the debtors of the nation and so they become the debtors. At the same time the professional friends of the poor, from Jack Cade to Bryan, with the childlike idea that the poor are the debtor class, have urged the cheapening of the currency. The relatively poor put their money in savings banks, which in turn buy bonds issued by corporations; small investors buy bonds themselves; they buy life insurance, their premiums being invested in bonds; and they do not borrow, partly because nobody will lend them anything. So, when the value of the dollar decreases, as it always does, they lose, and those who borrow their savings win.

To induce the small investor to buy bonds, graphs are made up to show the relative steadiness of the prices of bonds as compared with stocks, and the return on bonds if held to maturity is given with great accuracy, always on the assumption that a dollar is a dollar and forever worth the same. The decrease of dollar value which has averaged five per cent a year for twelve years is not thought worth mentioning.

We also have professors, with their Sprague's tables and logarithmic formulæ, who tell us to the hundredth of one per cent what return a fifty-year bond bought at 101 15/16 will give us; and what part of the interest must be set aside on a basis of scientific amortization to maintain the principal unimpaired. Will they tell us what that principal will buy when the bonds mature? If one were measuring the cubic content of the pyramids these professors would come running up with half a brick saying, "See, you have left this out," with eyes unseeing that the rule had shrunk by half and was shrinking.

They have measured the national wealth and income with their lessening measure and after a time measured it again; and they cry: "How great the growth, how rich we are," and government, willingly enough, taxes the increase.

Life insurance has been referred to, but it is only as an investment that the remarks have been intended to apply. There are those who have taken upon themselves such responsibilities that it is imperative on them to make provision against possible early death. For them the premiums they pay have two components: one a portion paid for protection, the other a portion paid as an investment. For the company there is but one component; the

number of their policy-holders is so great as to establish a statistical average upon which they can rely. A man is 61; so far as the company is concerned it may say with certainty that for their purposes he has $13\frac{1}{2}$ years to live; so that for an insurance of \$1,000 he must pay annually a sum that will amount in $13\frac{1}{2}$ years, at some previously fixed rate of interest, to \$1,000. Examination of life-insurance rates with an annuity table will show the rate of interest allowed. It is always less than bonds would pay, as indeed it must be since the premiums are invested largely in bonds and out of the interest must be taken commissions, operating expenses, profits and those monumental buildings that adorn our cities.

As a protection, then, life insurance is a necessity to some; they pay for it. As an investment it is an absurdity, largely so because life-insurance companies must invest their funds in precisely those securities that are the poorest investment for others. The excuse is, of course, a mythical safety attached, in the minds of our lawmakers, to evidences of indebtedness as compared with the part ownership of material things.

The matter is perhaps now more clear. If we buy bonds we invest in futures of a commodity—money—that has been falling in purchasing power since the memory of man runneth not back to the contrary. If we buy common stocks we invest in actual existing things that may be expected to rise in price—not in real value—just as fast as the cost of living rises, with further gain, if the stocks are preceded by preferred stock and bonds, of the amount lost by them in the rise of prices.

Which is the conservative investment? Is it conservatism to assume that some loss is necessary and choose the least of the losses, while another course is open without loss but with gain?

Altogether one is reminded of Teufelsdröckh:

“Toward anything like a Statistics of Imposture, indeed, little as yet has been done; with a strange indifference our Economists, nigh buried under Tables for minor Branches of Industry, have altogether overlooked the grand all-overtopping Hypocrisy branch; as if our whole arts of Puffery, of Quackery, Priestcraft, Kingcraft, and the innumerable other crafts and mysteries of that genus had not ranked in Productive Industry at all.”

* * * * *

So far common stocks have been spoken of as a class. There are, however, different classes of common stocks in which form of organization, legal and commission controls and character of assets bring about in a period of rising prices results departing widely from the general average.

There is, first, a class including railways, gas and water companies, and some other public utilities for which a limited or specific return is prescribed. This return may be computed as a fixed percentage on cost, on present replacement value, or on "actual investment." If the percentage or other limit of income prescribed is to be applied to the first cost of the properties, and if in the future no increase is to be allowed, the common stocks have the same losses as bonds when prices rise.

If present value is used as a basis, then for those who originally invested in the stock a proper allowance is made for any depreciation of the dollar in the past but with no hope for the future. If future rates are to be based upon values to be fixed from time to time the stock is in the class of investments protected against fluctuation in value of the money unit.

It might be said that public utilities have earned profits far in excess of those necessary to pay a reasonable return and to keep pace with the falling value of money. Some have done so; some have barely paid expenses; some have gone to the wall. The policy of governments, federal, state or municipal, has fluctuated in the past between wide extremes. The tendency today is towards a more stabilized condition in which public authority recognizes that it is not wise, even if it is practicable, by restriction to limit profits of utilities to inadequate returns; and the utilities are recognizing that reasonableness on their part will produce more satisfactory results than will excessive exactions from the public. Exceptions are to be found—the transportation situation in the city of New York being a striking one—but these are relatively infrequent and usually attributable to some special influence or condition. Variations from average conditions are found when the assets of a company are either predominantly capital or predominantly current. Where prices rise the benefit of the apparent increase in value of fixed assets does not at once appear. They remain on the books at original cost for many years, and in the current profits appear only those gains arising from current operations, plus an additional gain due to the use of plant obtained at a lower price than would have to be paid for replacement—the depreciation provision, for instance, being less. On realization of the whole business the increased price of fixed assets partly compensates for the decreased value of money, but not wholly, because some part of the apparent gain has appeared in current earnings. Indeed, over a period sufficiently long,

earnings would absorb almost all the gain in money value of fixed assets, since these must be replaced at current costs from time to time. Few, indeed, of our enterprises have such a long history as to produce such a condition.

Where the assets are principally current assets, however, there is little accumulation of increased price to compensate for decreased purchasing power of money. The current earnings are inflated by the constant absorption of the price changes. For example, a corporation had a capital in 1900 of \$200,000; it has been engaged in wholesale high-grade dress material merchandising; all its "profits" have been paid out in dividends. At this time its capital enables it to own a little less than half as much merchandise as it could own in 1900. The other half has been distributed as profits. All merchant companies, film companies, amusement enterprises, proprietary-medicine manufacturers, and other companies with little fixed plant pay out as dividends, or at least show as profits, part of the purchasing power of the original capital, and in that respect their common stocks approach the status of bonds.

Companies of this kind should show current earnings on a scale materially higher than those of enterprises with large fixed assets, and the stockholder should, in his own mind, classify part of the dividend and accumulated surplus, if any, as representing depreciation of the money unit, rather than an increase in the real wealth of the businesses.

There are companies with much capital in fixed assets, with no capital liability but common stock, and no bonds. These companies approach nearest to the condition where apparent earnings are true earnings, and the loss of purchasing power of money is compensated by the increasing price of the fixed assets. If such fixed assets exactly equalled the common stock, the adjustment would, at first, be perfect; but as the fixed assets were replaced or their depreciation provided for on the basis of book value, not current replacement costs, the equilibrium would be gradually disturbed and there would be some inflation of current income with a loss of real value of fixed investment.

Finally there are companies with large fixed assets, bonded debt, preferred stock and common stock. As all the increment of price arising from the falling dollar value goes to the common stock these companies should in theory accumulate for that stock not only the increment of price in respect of the

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BY SIDNEY S. BOURGEOIS

An exhaustive search throughout the country for accounting data relating to the manufacture of oleomargarine has revealed that very little, if anything, has been written on this subject. Probably this is to be accounted for by the fact that executives engaged in the industry have had more than their share of trouble in other phases of the business, notable among which has been the long struggle for existence.

Oleomargarine manufacturers may be classified in two groups, those engaged in the production of oleomargarine from vegetable compounds, and others engaged in producing oleomargarine from animal fats. This article will cover the accounting practice in a corporation of medium size, manufacturing oleomargarine from vegetable compounds, although it is not expected that accounting methods would vary greatly between the two types of industries.

At the outset it may be stated that exceedingly accurate accounts can be maintained in an oleomargarine factory, owing to the simplicity of the manufacturing processes. Unit costs are therefore conveniently and easily ascertained.

The oleomargarine factory typifies essentially the dual nature of a continuous process and a synthetic industry. A group of various raw materials is uninterruptedly and continually passed through a comparatively simple and definite process, and fabricated—synthesized—into a single finished product. This is altogether unlike the intermittent and the analytical industries, where raw materials are passed through complicated and interrupted processes and analyzed into finished goods of several varieties, and where the problem of allocating costs to each product, as well as finding unit costs, is often difficult and conjectural.

Latest available government statistics indicate that the following classes and quantities of commodities were consumed as raw materials in the manufacture of oleomargarine in the United States during the fiscal year ending June 30, 1924:

	Pounds	Percentage of total
Cocoanut oil.....	83,059,000	28.21
Milk.....	69,090,000	23.46
Oleo oil.....	52,265,000	17.75

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Neutral lard.....	32,210,000	10.94
Cottonseed oil.....	20,640,000	7.00
Salt.....	20,593,000	6.99
Peanut oil.....	5,657,000	1.92
Oleo stearine.....	5,317,000	1.80
Oleo stock.....	2,756,000	.94
Butter.....	1,900,000	.65
Miscellaneous materials (consisting of corn oil, sesame oil, soda, coloring, mus- tard oil, palm-kernel oil, edible tallow, soybean oil, sugar and extract of vanilla).....	976,000	.34
	294,463,000	100.00

Oleomargarine is manufactured in two colors, yellow and white. Usually the only difference in quality between the yellow (colored) and white (uncolored) is the infusion during the blending process of a small quantity of butter coloring in the materials in order to produce a yellow or butter color. With white oleomargarine, a capsule containing butter coloring is included in every one-pound package, in order that the consumer may mix the contents with the oleomargarine to produce a substance of butter color. The difference in cost of production between the colored and uncolored products is so insignificant that it has never been found practical to attempt the computation.

There is, however, a very marked difference in the excise tax paid on the white product and that paid on the yellow. The United States government requires the placing on original containers, prior to leaving the factory, of a ten-cent revenue stamp for every one-pound package of yellow oleomargarine, while the white product is similarly taxed at the rate of only a quarter of a cent per pound, notwithstanding that no change in quality results from the addition of butter coloring.

The manufacturing cost of the two colors of products being virtually identical, it is necessary for the manufacturer to include the additional nine and three-quarters cents per pound in the selling price of the yellow product. For this reason excise taxes should be treated on the operating statement as a direct deduction from sales.

In the particular factory referred to in this article, the finished product is distributed, for the most part, direct to retail stores, restaurants, etc. Some few sales are made to wholesale establishments.

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The final stage in the actual production of oleomargarine is the churning of the compounded materials. The finished product is removed from the churners and generally placed in ninety-pound cube-shaped wooden containers. The white product is subsequently cut into one-pound, and the yellow into quarter-pound sizes, wrapped in parchment paper, and placed in one-pound cardboard containers. These one-pound containers are afterwards placed in original packages containing ten or thirty pounds each.

INVENTORY CONTROL

It is highly desirable, and probably essential, to maintain perpetual inventories of all raw materials and finished goods, especially the latter. These can be kept very simply and with very little effort in pounds, gallons or whatever units of weight or measurement are most convenient. It is not necessary to consider monetary values in the perpetual inventories, as all materials and finished product are consumed and shipped immediately and usually there are no sudden and violent fluctuations in market prices of the raw materials or finished oleomargarine. On the contrary, they are rather stable commodities.

The record of perpetual inventories may take the forms of exhibit A (see page 345) for raw materials and exhibit B (see page 346) for the finished product. It will be observed that the pounds, gallons, or any other unit of weight or measurement used of materials and product may be known on any given day. These should agree, to a reasonable degree, with the physical inventories taken monthly.

The sources of information for the maintenance of the inventory records are the daily materials report (exhibit C, page 347) and the daily production report (exhibit D, page 348).

The initial step upon purchase and receipt of raw materials in the factory is to record the number of pounds or gallons on the line marked "purchased" (materials perpetual inventory, exhibit A). As the raw materials are processed, the pounds or gallons are entered under their proper captions on the daily materials report (exhibit C). As this form provides for a record of the total weights of materials used for each churning, with a knowledge of the total weight of oleomargarine manufactured therefrom it is a simple matter to compute the percentage of shrinkage resulting from each churning. The efficiency of the plant can thus be gauged accurately on each individual churning, so that the

average percentage of shrinkage in materials for the month can be held down to the lowest possible point consistent with legitimacy.

The daily production report (exhibit D) shows the result of each churning every day. The reason for using the ninety-pound cube as the unit in the production report is that the freshly made oleomargarine, while contained in cubes, is frequently stored in the factory refrigerator pending conversion into one-pound packages. Since one of the important purposes of these records is to insure a minimum amount of pilferage or other wastes, their function would be nearly defeated without a record of the original output from the churners. If stored for a day or two with no record kept, there could be no assurance that the stock had not been disturbed between the time of removal from the churners and the act of placing the product in smaller packages for distribution.

When the materials and production reports are turned in to the office, proper entries are made on the perpetual inventory records. The quantities of materials put in process are entered opposite the word "used" (exhibit A). The quantity of oleomargarine manufactured is entered opposite the word "manufactured" (exhibit B).

Should any of the materials be returned or sold, or wasted in any manner other than natural shrinkage in process of manufacture, these facts are recorded opposite their respective designations under the proper dates, on exhibit A. The combined quantities used, returned or sold and wasted constitute a proper deduction from the total of stock on hand at the beginning and purchases. The difference represents the stock of materials which should be on hand that day. This quantity is then brought forward to the next date opposite the designation "stock on hand." The procedure is continued each business day until the end of the month, when the physical inventories are taken and compared with the perpetual records. Any material variation between the two should be thoroughly investigated and reconciled, as the utter simplicity of the procedure should result in virtually exact agreement between the physical and perpetual inventories. The actual physical inventories are, of course, used as the starting point for the next month.

Practically the same procedure is involved in keeping the record of oleomargarine inventory, with due consideration to its differ-

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ence in nature. Whenever free samples are distributed, it is imperative that accurate record should be made of the withdrawals from stock, for two reasons. The cost of the sampling is a selling expense, and should therefore be included among the selling expenses and reflected as a reduction in cost of sales. Then, too, the withdrawal of stock without keeping a record thereof would seriously interfere with the efficacy of the perpetual inventory plan. The second reason is that the federal government requires the payment of the usual excise taxes on oleomargarine used for sampling purposes as well as on product actually sold.

GENERAL BOOKS

Unlike the accounting procedure found necessary in many manufacturing enterprises, in the oleomargarine industry it is not advisable, and is in fact cumbersome, to carry on the books such accounts as goods in process, finished goods and cost of sales.

Unit costs are ascertained so simply without this procedure that it would be a waste of effort. All that is necessary is a cumulative record of raw-material purchases, labor and manufacturing expenses. They may be carried cumulatively on the general ledger for the entire fiscal year, there being no necessity to make actual physical closings of the books more frequently. Monthly or quarterly statements of operations and financial condition may be obtained by the use of working trial balances. All necessary information for this purpose is to be found on the general ledger, with the exception of inventories, deferred charges and accrued expenses. The inventories are brought into the statements by a charge to asset account and credits to raw material accounts (or, in the case of finished goods, by a deduction from cost of sales). Deferred charges and accrued expenses are handled in the usual manner. Valuations are generally made at actual cost of raw materials and the cost to manufacture finished oleomargarine.

The following accounts, relative to operations, should appear on the general ledger:

<i>Sales</i>	<i>Cost of sales</i>
Yellow oleomargarine	Oleomargarine inventory (beginning of period)
White oleomargarine	Raw materials:
<i>Sales deductions</i>	Cocoanut oil
Revenue stamps—yellow	Peanut oil
Revenue stamps—white	

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<ul style="list-style-type: none"> Milk Benzoate of soda Salt Butter color and capsules Etc. Labor (manufacturing) Containers and wrappers Manufacturing expenses: <ul style="list-style-type: none"> Power Lights Fuel Insurance (fire, steam boiler, workmen's compensation, etc.) Water Taxes (on plant, inventories, etc.) Royalties (if any) Depreciation—plant equipment Depreciation—building Repairs—plant equipment Repairs—building Ammonia Miscellaneous Samples (credit) Oleomargarine inventory (end of period) <i>Delivery and shipping expenses</i> <ul style="list-style-type: none"> Truck drivers Truck upkeep Truck gas and oil Depreciation—trucks Freight and charges Miscellaneous 	<ul style="list-style-type: none"> <i>Selling expenses</i> <ul style="list-style-type: none"> Salesmen's salaries and commissions Salesmen's traveling expenses Advertising Salesmen's automobile upkeep Salesmen's automobile gas and oil Depreciation—salesmen's automobiles Free samples Miscellaneous <i>Administrative expenses</i> <ul style="list-style-type: none"> Salaries Stationery and supplies Postage Taxes (capital stock, internal-revenue license, etc.) Telephone and telegraph Auditing Insurance (fidelity, robbery, etc.) Depreciation—furniture and fixtures Legal Traveling Dues and subscriptions Miscellaneous <i>Other deductions</i> <ul style="list-style-type: none"> Interest paid Bad debts Discounts allowed Etc. <i>Other income</i> <ul style="list-style-type: none"> Discounts earned Sales of empty containers Etc.
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UNIT COSTS

It is of great importance to oleomargarine manufacturers, as it is in nearly all manufacturing enterprises, to keep close observance of the cost of manufacture. A very convenient method of doing so is to reduce all costs to a one-hundred-pound-unit basis. In other words, the cost of every item on the statement of manufacturing costs should be based on the average one-hundred pounds of oleomargarine manufactured during the period. The total quantity produced during any period can be obtained from the perpetual inventory records. In this way, variations in cost

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between similar periods can be noted, and corrective measures may be applied to any unfavorable tendencies.

It has also been found of material benefit to compute unit costs of delivery, shipping, selling and administrative expenses—that is, of course, based on the quantitative volume of sales. Total number of pounds sold for any period can also be found by reference to perpetual inventory records.

GOVERNMENT REPORTS

The bureau of internal revenue of the United States government requires of all concerns engaged in the manufacture of oleomargarine, a monthly report showing in pounds the consumption of each class of raw material, the total production of oleomargarine during the month and the total sales during the month. The production and sale of yellow and white oleomargarine has, of course, to be shown in separate quantities, owing to the difference in tax rates. The name and address of each customer during the month, as well as quantities, must be reported, and this report must also agree with the general report showing total quantities sold. Through this procedure the government is able to verify the correctness of revenue stamps used during the month.

The material, production and inventory records referred to in this article have been planned and adapted to the oleomargarine industry with the purpose in mind of facilitating the compilation of the monthly government reports. All information required therein can be ascertained from these records if they are properly kept.

AUXILIARY INFORMATION

In addition to the usual financial and operating statements, various analyses of the productive efficiency of the plant may be made. Let us take the following hypothetical case as an illustration:

Quantity of oleomargarine manufactured	330,000 lbs.
Raw materials consumed:	
Cocoanut oil	268,000 lbs.
Milk	69,000 "
Peanut oil	34,000 "
Salt	15,000 "
Benzoate of soda	700 "
	386,700 lbs.

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Oleomargarine manufactured (as above).....	330,000 lbs.
Shrinkage—in weight.....	<u>56,700 "</u>
Shrinkage—in percentage.....	14.66%
Percentage of production to materials consumed....	85.34%

Based on these figures, the materials necessary to produce 100 pounds of oleomargarine were the following:

Cocoanut oil.....	81.21 lbs.
Milk.....	20.91 "
Peanut oil.....	10.30 "
Salt.....	4.55 "
Benzoate of soda.....	<u>.21 "</u>
	<u>117.18 "</u>

When the plan outlined in this article is carefully adhered to, the true history of operating activities will be clearly reflected in the records, from which intelligent statements for the guidance of the executive can be prepared.

Exhibit "A"

MATERIALS
 PERPETUAL INVENTORY
 Standard Margarin Company
 Material: Coconut Oil Period: July 1st to July 31st, 1925

Dates	July 1st	July 2d	July 3d	July 4th	Etc.,	Etc.	Total
Stock on hand.....	16,000	13,500	12,500	13,600			
Purchased.....	6,000	7,000	9,000				
Total.....	22,000	20,500	21,500				
Used.....	8,000	7,500	7,900				
Returned or sold....	-0-	500	-0-				
Wasted.....	500	-0-	-0-				
Total.....	8,500	8,000	7,900				
Net stock on hand...	13,500	12,500	13,600				

Exhibit "B"

OLEOMARGARINE
PERPETUAL INVENTORY
Standard Margarin Company
Color: Yellow Period: July 1st to July 31st, 1925

Dates	July 1st	July 2d	July 3d	July 4th	Etc.,	Etc.	Total
Stock on hand.....	10,000	9,400	9,595	10,055			
Manufactured.....	10,890	10,700	10,400				
Returned.....	50	25	10				
Total.....	20,940	20,125	20,005				
Sales.....	11,500	10,500	9,900				
Samples.....	40	30	50				
Total.....	11,540	10,530	9,950				
Net stock on hand...	9,400	9,595	10,055				

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DAILY MATERIALS REPORT
STANDARD MARGARIN COMPANY

Exhibit "C"

Date.....192..

MATERIALS PUT IN PROCESS

For Churning No. 1—Date....192.. For Churning No. 2—Date....192..

<p><i>Cocoanut oil:</i> <i>Regular:</i> Barrel #1... lbs. Barrel #2... " Total... lbs. Barrel #3... " Total... lbs. <i>Hard:</i> Barrel #1... lbs. Barrel #2... " Total... lbs. Barrel #3... " Total... lbs. <i>Peanut oil:</i> Barrel #1... lbs. Barrel #2... " Total... lbs. <i>Milk:</i> ... gals. Total... lbs. <i>Salt:</i> ... lbs. Total... lbs. <i>Benzoate of soda:</i> ... lbs. Total... lbs. <i>Butter color:</i> ... qts. Total... lbs.</p> <hr/> <p style="text-align: right;">Grand total. lbs.</p>	<p><i>Cocoanut oil:</i> <i>Regular:</i> Barrel #1... lbs. Barrel #2... " Total... lbs. Barrel #3... " Total... lbs. <i>Hard:</i> Barrel #1... lbs. Barrel #2... " Total... lbs. Barrel #3... " Total... lbs. <i>Peanut oil:</i> Barrel #1... lbs. Barrel #2... " Total... lbs. <i>Milk:</i> ... gals. Total... lbs. <i>Salt:</i> ... lbs. Total... lbs. <i>Benzoate of soda:</i> ... lbs. Total... lbs. <i>Butter color:</i> ... qts. Total... lbs.</p> <hr/> <p style="text-align: right;">Grand total. lbs.</p>
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Approved:

.....
Stock keeper

.....
Factory superintendent

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DAILY PRODUCTION REPORT
STANDARD MARGARIN COMPANY

Exhibit "D"

Date.....192..

Yellow

Churning No. 1	Churning No. 2
.....90# cubes, or.....lbs.	.....90# cubes, or.....lbs.
.....60# tubs, or.....lbs.	.....60# tubs, or.....lbs.
.....30# tubs, or.....lbs.	.....30# tubs, or.....lbs.
.....5# tins, or.....lbs.	.....5# tins, or.....lbs.
....., or.....lbs.	....., or.....lbs.
Approved:	Approved:
.....
Factory superintendent	Factory superintendent
.....
Stock keeper	Stock keeper

White

Churning No. 1	Churning No. 2
.....90# cubes, or.....lbs.	.....90# cubes, or.....lbs.
.....60# tubs, or.....lbs.	.....60# tubs, or.....lbs.
.....30# tubs, or.....lbs.	.....30# tubs, or.....lbs.
.....5# tins, or.....lbs.	.....5# tins, or.....lbs.
....., or.....lbs.	....., .....lbs.
Approved:	Approved:
.....
Factory superintendent	Factory superintendent
.....
Stock keeper	Stock keeper

Taxable Income

BY ARTHUR A. BALLANTINE

[The paper by George O. May, read at the annual meeting of the American Institute of Accountants and published in THE JOURNAL OF ACCOUNTANCY for October, 1925, was followed by a general discussion led by Arthur A. Ballantine. In the following report of Mr. Ballantine's remarks the frequent references to statements made by Mr. May relate of course to the paper which appeared in this magazine last month.—EDITOR.]

As Mr. May has branded the legal mind as suspicious of anything more complicated than a cash account, it is perhaps hardly fitting that a lawyer should begin the discussion of Mr. May's excellent paper. At the same time, he has expressed astonishment at the accounting notions of economists, and so I suppose you might as well go to a lawyer as anywhere else if you are going outside this select group at all. As Mr. May has very graciously added, along towards the close of his paper, that accountants themselves are sometimes inconsistent in their phraseology, and I might add from experience also at times a little copious in their phraseology, perhaps I can indulge the legal passion for simplification on Mr. May's paper. He is so convincing that I am sorry to say that I cannot quarrel with him very extensively, but I should like to emphasize the importance of some of the views which he has expressed. His own moderation and suavity may belittle the practical importance of what he says.

The effect of Mr. May's paper ought to be to destroy a myth which has worked a great deal of mischief in income-tax legislation and in income-tax administration—that myth of the existence of some one ideal system of accounting, furnishing a fixed formula by which all accounting questions can be solved. As Mr. May has said, that idea has been pretty well eliminated from the law itself. His object is now to drive it from its last lurking place among the administrative offices in the bureau of internal revenue. We often find there even today that in accounting matters officers tend to proceed on the basis of the country doctor who said he was all right if he could throw the patient into fits because he was great on fits. They are all right if they can throw the tax problem into the basis of accrual accounting because they are great on accrual accounting. Now, as opposed to this view of a fixed method of accounting, I understand Mr. May to take the position that accounting consists in the application to complicated subject matter of various principles which are founded upon reason and experi-

ence, among which a choice must be made. He would substitute the rule of reason for the sway of the shibboleth.

I was impressed by Mr. May's apt definition of income. He has said that it would be fairly accurate to say that the general test of the existence of income is whether there is a gain, but that items which ordinarily constitute gain and are commonly regarded as income, may be taxed as such, even though in exceptional cases they may not result in gain to the recipient. He has very neatly summed up there the effect of the decisions of the supreme court as to the meaning and nature of income. He takes in, of course, the leading case of *Doyle and Mitchell*, where it was established that the gross proceeds of the sales are not by any means income, but that you must first take out the original capital represented by the subject matter of the sale. He takes in the treatment of dividends, as dividends have been treated in the law, as being inherently of the nature of income, notwithstanding their relations to their particular recipients, and he also takes in the more recent *Gavit* case, in which it was held, in interpreting the 1913 act, that the proceeds of income from a trust fund given to a recipient for life or for a period of years was of the nature of income and taxable as such, and the claim of the recipient who had tried to set a capital value against such receipts and make a deduction for the recovery of that value was rejected by the court. All those views come into Mr. May's definition.

The decision of the matter of depletion, to which Mr. May has referred, has left the legal status of that important matter in some doubt. I think that doubt exists largely because of the way in which the matter of the depletion deduction has been presented to the supreme court. In the original case of *Stratton's Independence*, which arose under the 1909 act, the excise-tax act, as Mr. May said, the company contended that it was entitled to subtract from the gross proceeds of the mineral product the entire excess of those proceeds over the cost of the mining operation, with the result, of course, that there was no profit from the operation at all, and that the entire result from the sales over the expenses was to be treated as a return of capital. Now, the only question presented to the court in this case was whether that particular deduction was authorized. The court had no alternative to say what would have been a correct deduction from the gross income, if any were in order, and carefully pointed that out. In the succeeding case of *Stanton & Balte Mining Company*,

which arose under the 1913 act, the true income-tax act, the company again in effect took the position that the entire proceeds from mining were exempt from the tax, and did not present a view as to what might be a reasonable deduction for a return of capital from the mining operation. The taxpayer was, of course, objecting to the arbitrary limitation in the act of the depletion allowance to 5% of the gross proceeds, but did not present a view as to what a really proper deduction might be, which might admit of a profit in a mining operation. In that instance the court followed the Stratton Independence case, even though that case was decided under the excise-tax act. I do think that that decision in itself, the Stanton & Balte Mining Company, seems to indicate on its face that, following English decisions, the court would have sustained the act even though a reasonable deduction for depletion was actually shown on the record to be in excess of the 5% limitation. Such a result would be inconsistent, as Mr. May has indicated, with the view which the supreme court has generally taken, that income is essentially gain. It was inconsistent with the result in Doyle and Mitchell and therefore I think and hope that we should find, if the question of a proper and reasonable depletion were presented, that the court would hold that in case of the operation of a mine, there must be an allowance for a return of capital as much as in the case of the timber companies. With that exception, which Mr. May noted, the supreme court has certainly sustained the view that income is in the nature of gain.

Now we come to Mr. May's statement of how we are to get at the gain, and there he makes the proposition which undoubtedly is very obvious to accountants but has not seemed so obvious to taxpayers at times or to the bureau, that gain is the result of the difference between two sides of correctly kept accounts. In commercial operations it is not to be computed item by item. He points out that the question of what goes into those two sides is a matter involving judgment, discretion, the use of experience, and that being true as to the two sides of the account, the result as to what is gain is necessarily a matter of judgment. He further points out that particularly in the case of industries where the results of operations extend through more than one year, the question of allocating items entering into one side of the account or the other to a particular year is a matter of judgment, and not a matter of absolute logical demonstration, and the judgment must be exercised with reference to the exigencies and the nature of the

particular business which is involved. If those views as to the nature of gain and the way of getting at it are accepted in income-tax administration, it follows that the discussion of the status of any particular practice and the solution of any particular problem depends on consideration of that particular problem and getting at what is the result to be accepted as reflecting the business truth in the light of the experience of business men and not a matter of resorting to any formula or any a priori notion of what the result ought to be. I am sure that it is a result with which all are in accord, and that endorsement of that view will help in the solution of tax problems.

Mr. May's observation that there is a fundamental distinction between the determination of what deductions from income are authorized and the determination of what constitutes gross income seems to me of much importance. We find traces, as indicated, of the view in the bureau that in getting at what constitutes gross income, there may be deductions which do not fall within the express provisions for deduction in the act, but the fact has not been broadly and clearly recognized that the determination of gross income and the determination of authorized deduction from gross income is a fundamental accounting notion. An illustration of that, although not in the field of commercial income to which Mr. May has devoted his discussion, came up to me a short time ago in the case of a trust. A very large trust was left and a provision was made in the will which created the trust for the payment of fixed amounts to the trustees. Those fixed amounts were very small. The small amounts fixed in the will might have been well enough while the original trustees, who were friends of the testator, were operating the trust, as they would do it as a matter of friendship, but as that time got further back, and as the trustees changed, it was obvious that in order to get proper administration of the trust the beneficiary would have to pay very much larger compensation to the trustees. The beneficiary therefore entered into a contract with the trustees under which it was provided that if the trustees would continue to act, the beneficiary would make very substantial additional payments. Those payments were finally made and deducted from the income returns of the beneficiary. The bureau so far has taken the view that those deductions made by the beneficiaries were not authorized because they could be authorized only if the beneficiary was carrying on a business and they were business deductions. The beneficiary was

stated not to be carrying on a business and therefore it was concluded that there was no provision for deductions of that sort. The contention was made in behalf of the taxpayers that the business was being carried on by the trustees for the account of the beneficiary, but beyond that it was contended that the tax rests upon the income of the beneficiary, and the gross income of the beneficiary is the amount received less expenses necessarily incurred in the realization of the income, and on that principle which Mr. May has here pointed out those deductions are allowable by the act. I am glad to find that Mr. May's principle so firmly supports the position which was taken in this particular case.

Mr. May has said something about the attitude and principles to be adopted in solving the tax problem and has expressed the idea that the deductions which are to be permitted to taxpayers, following the general accounting basis as he has indicated, cannot be such as to rest simply upon the discretion of the taxpayer. He has said that in a determination of income for general purposes, principles of conservatism are to be followed in not recognizing any item of gross income until it is an actual realization or what is expected in all reasonable probability to be a realization; that business men must also provide for losses which are foreseen even in advance of the realization of those losses if they are to tell themselves a true and proper story of the result of the business as it goes along; but he has pointed out that the revenue officers and congress could hardly be expected to permit deductions which must rest solely upon the discretion of the particular taxpayer. That, of course, has been a point of controversy in the bureau. It was of the greatest importance to taxpayers that the ruling was established in 1917 that inventories could be taken on the basis of cost or market, whichever was lower. That meant that where the inventory was less than cost, the taxpayer was taking an anticipated loss, not a realized loss; he might never realize that loss but he was nevertheless permitted to take it. That was permitted because it was an established practice of conservatism, but there was also another consideration which entered into the recognition of that practice. That consideration was that the determination of the amount of loss to be taken could be made irrespective of the judgment of that particular taxpayer. The probable loss allowed to be taken was based upon the difference between cost and actual market prices. Taxpayers constantly urged upon the bureau that where the taxpayer, a business man, in his judgment foresaw

that the cost of goods was going down below the current market at the end of the year, he ought to be able to take an allowance for that expected loss. The bureau has never acceded to that view, but has limited the anticipated loss to a loss that can be measured by some standard external to the judgment of the particular taxpayer. It seems to me that congress must continue and the bureau must continue to adhere to that standard, as otherwise the taxpayer could determine in his own discretion when and whether he would pay his tax. That would seem to be a fitting subject for discussion.

The historical portion of Mr. May's paper I think is of very distinct help in understanding the development of the income-tax law. He points out that the 1909 excise-tax act took what is referred to as the "received and paid" basis for the determination of income. I do not think it is wholly fair to wish that on the lawyers. I think that was rather the ordinary layman's idea of how income was to be determined. The problem presented in adopting such a mechanical law as that, a law so far away from recognized commercial practice, was solved, as Mr. May indicated, with the help of accountants. I suspect his own hand was felt in the Gilbertian interpretation which saved that law. That interpretation did tend to leave people confused as to what the law meant when it was capable in some instances of such flexibility of interpretation while rigid in other respects, but the precedent of those Gilbertian regulations in 1909 was of enormous importance to taxpayers in dealing with the excess-profits law of 1917. The operation that had to be performed on the 1917 excess-profits law to get a reasonable and approximately just application of that act to the varying conditions of business, was far more drastic than the operation which had to be performed on the 1909 law. The light Gilbertian operation of 1909 was a very helpful precedent for the Cæsarian operation of 1917 and 1918.

As Mr. May says, the problem of getting a recognition in the statute itself of the use of a proper accounting basis is solved. It was solved also partly with the help of the despised lawyers. The problem now is as to the mind of the bureau, that is to a very considerable extent an accounting mind, and I am very hopeful that, with such weighty counsel as Mr. May has now given, the last difficulty will be removed. I am sure it will be most helpful in accomplishing that result if this distinguished and authoritative association sees fit to enforce and endorse the views which have been so well expressed by Mr. May.

The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

EDITORIAL

The Institute Rejects an Amendment

Among the many important matters under discussion at the annual meeting of the American Institute of Accountants undoubtedly the most important was the proposal that membership in the American Institute of Accountants should be restricted to certified public accountants. The proposition was overwhelmingly defeated, but its importance is enhanced rather than diminished by the practically unanimous nature of the opposition to it. When the amendment which would have established a restriction upon future admissions was put to vote there were only two who desired to be recorded in favor. Herein is a rather marvelous thing. For some years there has been at least a considerable minority of the members who have felt that the time had come when all those who desired to associate themselves with the national organization of professional practitioners should be required before admission to obtain a certificate as a certified public accountant in some one of the states or territories of the United States. The restrictive theory had been advocated by some of the leading members for several years. Three years ago a somewhat similar proposition was defeated, but on that occasion the number of votes in its favor indicated a body of opinion which deserved attention. This year an amendment designed to effect restriction was presented by the committee on constitution and by-laws at the request of several members, and, although the committee withheld recommendation, it was expected that there would be a fairly close division of opinion when the amendment was brought before the annual meeting.

The Situation Is Changed

In his presidential address of 1924 the retiring president, Edward E. Gore, expressed the opinion that the time had come when membership should be limited to holders of certified public accountant certificates. At the meeting of 1925 Mr. Gore

was one of the antagonists of the amendment. In his speech on the latter occasion he explained with great force the reasons for his changed opinion and apparently these reasons impressed nearly everyone present. The truth of the matter is that things have happened within the past year that would have been regarded as almost impossible a year ago. The sense of security in regard to the status of C. P. A. legislation has been shown to be not firmly founded, and many accountants are beginning to wonder where the lightning will strike next. From the beginning of accountancy legislation Illinois has been a leader in the maintenance of standards and the administration of law, yet this year Illinois has thrown overboard its former legislation and a condition of affairs has arisen which is altogether disconcerting. California escaped a similar disaster by the narrow margin of one vote. In Tennessee the legislation regulating the issuance of C. P. A. certificates seems to be chaotic in effect. In several other states during the activities of the last legislative year there were many attempts either to overthrow entirely or seriously to weaken the laws relating to the profession of accountancy. And we come therefore to the unwelcome conclusion that the regulation of a profession so long as it is even indirectly controlled by political exigency is ever in jeopardy. Most of us hope and believe that C. P. A. laws as a whole will continue to exercise a salutary influence upon the profession. It would be a thousand pities if the designation "certified public accountant" which has been advancing steadily for the past twenty-nine years were to lose its significance because of the uncomely somersaults of state legislatures. The voice of public opinion will certainly be heard in defense of what has now become the recognized official designation of the licensed practitioner, and even the most benighted legislator is able to hear through his mental darkness the voice of his constituents. There are some pessimists who predict that what has happened in Illinois will happen in many other states. Pessimists, as everyone knows, serve a useful purpose. They may be unpleasant, but their warnings are often preventive. In this case the sob of the crape-hanger is probably out of proportion to the burden of woe. A designation so well known as that of the certified public accountant cannot be utterly destroyed by the caprice of a few legislatures. Even in those states where there has been damage one may look with some assurance for a return to sanity.

**A Question
of Principle**

The question before the American Institute, however, was not so much whether the C. P. A. certificate would lose value or not as it was whether any designation whose issuance was not dependent upon the Institute's own will and wisdom should be regarded as a prerequisite to admission to the Institute. That organization, from the time of its formation, has always maintained the theory that a profession can best be regulated by itself. The licensing of a man or woman to practise as an accountant is entirely a state function, but the mere possession of a certificate from a state or other political power is not the criterion of ability in all cases. Every accountant knows that scores of C. P. A. certificates have been issued to persons who were not exceptionally well qualified. That was the first reason for the creation of the Institute. As time went on, however, there was a marked improvement in the administration of C. P. A. laws, chiefly because of the excellent examinations prepared by the Institute and adopted by a majority of the states. New laws or undesirable amendments became rare and there was more than a little reason to hope that certified public accountant as an official designation had become firmly established. This hope, as has been said, was ill-founded, at least in part.

**Some of the
Reasons**

But even if there had been no weakening of the C. P. A. fabric there would be many valid reasons to oppose any extraneous regulation of admissions to the Institute. Members who have followed the discussions which have taken place will not need to be reminded of the arguments for and against restriction, but the general public which has an interest in the welfare of accountancy—and, be it remembered, this magazine is circulated not only among accountants but very largely among persons who have a more or less indirect interest—may not be so clear as to the reasons for liberal entrance requirements to the Institute. In brief these reasons as put forward by many of the most eminent members of the profession include:

- First: The truth that accountancy is necessarily interstate in character.
- Second: Unless there could be absolute uniformity in all states and territories there could be no standard of proficiency which would have a nation-wide meaning.

Third: A profession must be unimpeded in its progress toward the highest professional ideals.

Fourth: The professional status depends first of all upon the observance of ethical principles which, of course, will not be adequately enforced unless the authority to enforce be vested in the profession itself.

Fifth: There have been and no doubt always will be some men and women who for one peculiar reason or another do not comply with some detail of regulation essential to acceptance by a state authority.

Sixth: It is only through the operation of a wholly impartial and professional organization, nation-wide in its scope, that the hall-mark of professional standing recognized throughout the country can be impressed.

In the minds of many members there are other reasons as well why there must be a professional organization.

Not Conflict
but Accord

All this is said not with any lessened degree of respect for the certified public accountant certificate. The Institute

has labored in season and out of season to encourage the enactment of good laws and the maintenance of those laws when enacted. It has assisted the administration of C. P. A. law in every part of the country. The activities of its board of examiners have been largely directed to fostering the good name of the certified public accountant. Its committees have aided the good and opposed the bad whenever and wherever a change in law or regulation was proposed. Anyone familiar with the facts who would deny these assertions could be animated only by malice. But that is not to say that the Institute must restrict its membership and exclude even one applicant who is worthy to be admitted and to present himself as the member of a learned profession. Most of the applicants of the future will be certified public accountants, and that is as it should be; but apparently the suggestion that membership should be restricted by anything except the Institute's own standards is laid to rest. The future holds great possibilities for development not only of the Institute but also of the administration of C. P. A. laws. The two things can march side by side and will do so.

Comparative Value
of Investments

On another page we publish an article entitled *Investments* by F. W. Thornton, who is well-known to most accountants as one of the authors of *Duties of the Junior Accountant*,

a book whose circulation continues year in and year out with unabated popularity. The subject which Mr. Thornton has chosen for his present discussion is the comparative merit of bonds and common stocks for long-term investment. This is a topic which has attracted a good deal of attention in the past few months. An excellent little book entitled *Common Stocks as Long-term Investments* by Edgar Lawrence Smith has been reviewed most favorably by the leading financial papers of the country, indicating that the subject is timely and of wide interest. The current number of the *Atlantic Monthly* contains an article by the same author expanding some of the theories which he enunciates in his book. Other authors have been expounding the worth of certificates of indebtedness having a fixed maturity at a fixed dollar value in comparison with the declining purchasing power of every monetary unit. Readers will find much food for thought in the arguments adduced by Mr. Thornton, and it is particularly important that accountants in their advisory capacity should be familiar with all the principal factors in value of the principal kinds of investment for corporate and individual funds. We have grown so accustomed to regarding so-called gilt-edged bonds as the last word in safety that it is something of a shock to most of us to be told that in many cases the ultimate value of what we have regarded as more or less speculative investments may be greater than the media which tradition has told us are safe and sane. Of course, as in all theories, there are two sides of the question. For short-term investment in which the prime consideration is the return of a certain amount of money at a certain date, the bond secured by mortgage upon valuable assets still remains the most desirable, and no one would urge the investment of all one's resources in the common stock of any one corporation. The old adage against the placing of too many eggs in one basket is founded upon truth. But this is not what Mr. Thornton and others of his school advocate. They are saying simply that a properly diversified investment in certificates of ownership is preferable in the long run to investment in certificates of indebtedness payable in a token of value whose purchasing power is variable. Mr. Thornton does not refer at length to the investment trust, an agency long popular in other countries and recently establishing itself here. The weakness, as we see it, of most American investment trusts is a lack of the diversification which makes for safety on the average. Many of those organiza-

tions in America restrict their investment to companies engaged in similar kinds of activity, and it is therefore easily conceivable that a combination of circumstances which would adversely affect one such corporation might affect all of its kind. The investment trust, however, does offer better opportunity for diversified investment than the small investor could probably obtain otherwise, and we should regard with high favor a venture of this sort which would adopt the principle of diversification not only among companies of a similar nature but also among companies of widely differing interests. Some of us who are ultra-conservative will still have a lingering fondness for the form of investments which are generically known as bonds. Within the last eleven years we have of course passed through a period which has upset all preconceived ideas. It may be that for generations there will be no other such disturbance of the purchasing power of the dollar, and there are those who believe that the tendency during the next few years, at any rate, will be upward rather than downward. Nevertheless there is much undeniable force in Mr. Thornton's arguments that an investor who ignores the fluctuating value of the dollar is blind in at least one eye.

**Definitions
Once More**

At the risk of incurring the displeasure, if nothing worse, of a few readers, let us return to a subject which has been discussed in many recent months, namely, the meaning of the expression "certified public accountant." To those readers who with an altogether pardonable alacrity have skipped over the editorial section of the magazine, it may be said that there are many people who feel that although they are not engaged in public practice there is no valid reason why they should not receive certificates as certified public accountants if they can pass the required examinations. It has been emphasized with what power was possible that the man or woman engaged in a private capacity with the making or control of accounts is in every way as worthy of respect as is the one whose accounting experience is in the public field. The one has no right to assume an air of superiority over the other. It has been said on several occasions that there is no question of rank but rather of kind. It has been said that anyone who is not in public practice should not be classified as a public accountant. Placing the word "certified" before the words "public accountant" has no bearing upon the proper significance of the word "public." Still some readers have

been dissatisfied by what has seemed to be an absolutely clear argument. Without any wish to exhume a buried controversy it is impossible to resist the temptation to publish the following letter from L. B. Cooke, of Tennessee, which we offer to close the incident, as they say in diplomacy:

"So much of my time has been taken for the past six years in endeavoring to build a permanent clientele and studying the United States tax laws, rulings and supreme court decisions, that I have had very little time for writing letters and I would not be writing this, though I constantly read THE JOURNAL OF ACCOUNTANCY, but for the fact that a gentleman, who formerly worked for me, while calling at my office today mentioned the fact that he was the party referred to in your editorial entitled, *The Meaning of a Word*, on page 117 of your August issue.

"I heartily concur in your views, that there is a vast difference between a private accountant and a public accountant, and believe that the vast majority of business men outside of the accounting profession fully realize the difference.

"I am outlining below a few of the reasons, as I see them, for this distinction:

"(1) A financial statement signed by a public accountant is supposed to be a true statement of facts, regardless of who may have employed him. (Though they may not be made public except through his employer.)

"(2) Special investigations for specific persons place the public accountant in the same position as a lawyer. Those statements not signed by the true public accountant bring out strongly one side of the situation and leave the other side to bring out their points.

"(3) I have found quite a number of business executives who change accounting firms from year to year for the reason as expressed to me that they feared continued association with trusted employees might cause the investigator to relax his vigilance. To prevent this situation arising I have continued to use the policy of changing men from one audit to another for the next checking period. You can readily see that the private accountant might be influenced in this way.

"(4) The private accountant after continuously checking trusted employees, whose work proved correct over a long period, might relax in his vigilance.

"(5) The private accountant has the viewpoint of *one* business, while the public accountant is each day coming in contact with the changes and progress of various businesses in various lines.

"(6) A private accountant may be just as efficient as a public accountant in the year 1925, but at the end of a few years the private accountant, regardless of study, will have experience in one business and the public accountant will have experience in hundreds of businesses, which will place him far in advance of the private accountant.

"(7) A private accountant with his entire income from one company or individual is more liable to be swayed into less careful analysis than the public accountant whose income is from hundreds of firms and individuals.

"(8) If a private accountant were allowed to sign as a public accountant the investor or the banker might be led to believe that the statements were signed by an impartial public accountant, and there would be no way for them to know that these statements had been furnished by a private employee of the firm.

"(9) I can not conceive of an educated individual who could be so biased as to be unable to understand the meaning of the word "public" even though it be attached to two other words. If there is such a person he might profit by a study of the definition in the dictionaries of our public libraries.

"I have endeavored to give you the unbiased facts as I see them from experience and trust that you will pardon my inexperience in letter-writing."

**The Marshall
Reminiscences**

Everyone who has been reading the delightful reminiscences of the late Thomas R. Marshall has been impressed not only by the charming humanity of the man but by the extreme breadth of his interest. He seems to have touched upon almost every phase of activity, and in each case he has said something worth hearing. The accountant has not been forgotten. Speaking of the time when he was governor of Indiana he said:

"I have always felt that there was one good bit of constructive legislation enacted during my term as governor. It was the putting in of the public accounting system, whereby the books, papers and documents of every official in the state is examined by certified public accountants—one from each party—every year, and the official is then checked out, or, if he is short in his accounts, is compelled to adjust them."

This was serious comment, but the splendid, lovable fellow could not be serious long and so he had to tell a story to illustrate the fact that he knew something about accountants. This is the story:

"Shortly after this system was inaugurated two of the accountants came into my office with what I think is an amusing incident and a remarkable statement of the inherent honesty of some men. They told me they were examining the records of a certain township trustee, in the southern part of the state. This man was of German extraction. They found that he had charged himself in the road account of his township with 'Graft—\$20.00.' This excited their curiosity and they asked him to explain the item. He did, to this effect:

"He said he was desirous of buying a road scraper, and there were three or four agents seeking to sell one to him. He liked the appearance of one young man better than the others, and as the prices were substantially the same, he bought the road scraper of this man. When he had concluded the contract he walked down to the train with him, and as the young man got on the train he shook hands and said good-bye. As this ceremony took place he found in his hands a \$20 bill. He said to the agent: 'Here! You have left \$20 of your money with me.' The agent said: 'No, that is yours.' The trustee said: 'Why, how is that mine?' The agent said: 'Why, you blamed old fool, that's graft!'

"'And,' continued the trustee to the accountant, 'as I knew it did not belong to me I just put it in the road fund and entered on the books to the effect that it was graft.'"

Here is a fine point in accounting technique. What would the students in an auditing examination suggest as the proper treatment for this item of "graft—\$20"?

**Explaining
a Rule**

There has been so much question in recent correspondence in regard to the meaning and application of the rules of the board of examiners of the American Institute of Accountants that it may not be amiss to repeat for general information some important points. The rule which seems to attract the

most attention is that which permits the board in certain circumstances to extend recognition to examinations other than those conducted by the Institute. For instance, a man who is a certified public accountant of a state with good standards or one who is a member of the chartered societies of the British empire or the incorporated society of England may apply to the Institute for admission and claim credit for the examination which he has passed to become a certified or chartered or incorporated accountant. This is where the misunderstanding frequently arises. There seems to be an impression that everyone who has this preliminary qualification must be admitted; and it becomes necessary for the board to repeat time and again the fundamental principle upon which recognition is based. The board does not extend a blanket recognition to the certificates of any state or society. Each application receives individual consideration and the board reviews the examination which the applicant has passed. It does not say to state boards that all applicants who have passed the examinations of those boards will be admitted. It insists that there shall be an opportunity to review the questions which have been set before the candidate. It gives consideration to the probability of fair grading and intelligent review by the examiners of the states or societies. It cannot be emphasized too strongly that all admissions to the Institute are individual and the circumstances surrounding each applicant determine his eligibility. There has never been admission of applicants as a group. That would be opposed to one of the fundamental principles upon which the Institute stands.

Income-tax Department

EDITED BY STEPHEN G. RUSK

During the coming winter much will be said with reference to modification, simplification and changes generally in the federal income-tax laws. The report of the Couzens committee is being awaited with intense interest. The incidents associated with the inception of this committee and the newspaper stories of the outgivings of its chairman have centered attention upon it. What has been found and what it will report and recommend is not as yet known with any degree of definiteness. However, it has been reported that Senator Couzens favors the exemption of all incomes up to five thousand and a reduction of surtaxes as much as or more than is now being contemplated by the secretary of the treasury.

Senator Couzens estimates that if incomes up to \$5,000 were exempt from taxation, ninety-one per cent of the tax returns now made would be eliminated. As he states, this would lift a burden of giant proportions from the personnel of the bureau of internal revenue. It would be interesting to know whether or not the cost of handling these returns, their examination, collection and filing is so large a part of the revenue derived from them as to render the net revenue insufficient to justify the expenditure of effort.

There is a theory that the obligation to pay a tax causes the taxpayer to take a greater interest in his government than do those not taxpayers. This theory seems to be too general to be accurate.

It is reported that Senator Smoot is in favor of the abolition of the estate taxes and the gift taxes but that this will be opposed to a certain extent by Senator Couzens and the bloc of which he is a representative.

Much attention is being given by those in authority in our government and those not of that body to proposals for a more scientific basis of levying and collecting the income taxes. One of the major problems of the treasury department in its work of assessing and collecting federal taxes is that of obtaining competent employees at the salaries that are prescribed. The vast majority of its employees are competent but the personnel is constantly changing for the very obvious reason that the salaries paid are below the scale of the business and professional world. No claim is made that this discovery is original with the writer. Everyone in contact with the taxing departments is aware of it. It would seem to be a duty of everyone having this in mind to make his influence felt in having this condition remedied, for with greater incentive and the ability to get high grade employees, satisfied to remain in the employ of the government indefinitely, there would be a great saving to the taxpayers. It costs money to employ men and instruct them in the work they are to perform.

SUMMARY OF RECENT RULINGS

Under the 1918 act, an action at law may not be maintained by the United States for an extra estate tax where the executor's return is incorrect, without a return by the collector and the assessment of a tax thereon by the commissioner, as prescribed by the statute. (*U. S. v. James C. Ayer, et al.*, in U. S. district court of Massachusetts.)

Income-tax Department

A partnership which carried on business solely with borrowed money had no invested capital under the 1917 act and was subject to tax under section 209 thereof and not to any excess-profits tax. (*King v. Hopkins, Collector, U. S. district court, N. D. of Texas.*)

When conservative valuations are placed upon lands by administrators in their estate-tax returns, such valuations will not be later held excessive on their motions although the market value of such land was greater at time of decedent's death than it was before or after that date.

When the year's taxes on real estate became a lien on May 1st of that year, the value of the estate of a person dying after that time should have deducted therefrom all of such taxes, notwithstanding article 40 of regulations in effect when the taxes were paid, October 18, 1920.

When taxes were voluntarily paid but a claim for refund was made, the question reopened by the government and a partial reduction allowed because of certain taxes paid, the courts may allow a further reduction on account of said taxes if considered proper. (*Thompson et al. Administrators v. U. S., U. S. district court of Minnesota, third division.*)

Goodwill is not "property used in trade or business" under the act of 1918, and an allowance for the obsolescence thereof may not be allowed because of prohibition legislation in the case of a manufacturer of malt. (*Red Wing Malting Co. v. Willcutt, Collector, U. S. district court of Minnesota, third division.*)

Where the value of corporate stock has been increased or decreased during the preceding year, the capital-stock tax must be based upon its fair average value during that year which is not the same as its fair value on June 30th. (*One Liberty Street Realty and Securities Corporation v. Bowers, Collector, U. S. district court, S. D. of New York.*)

Goodwill value for purposes of invested capital cannot be established by oral testimony or by proof of stock being issued therefor. (U. S. B. T. A. decision 666, docket 84, *Pacific Baking Company.*)

Earnings subsequent to the acquisitions of intangibles purchased for stock have evidentiary value in determining the worth of such intangibles.

The commissioner has the burden of proving the facts if an affirmative defense is alleged in his answer. (B. T. A. decision 667, docket 1858, *General Lead Batteries Company.*)

Where a taxpayer owes no obligation to declare a bonus, those declared after the close of a taxable year are not deductible from the income of such prior year. (B. T. A. decision 671, docket 1776, *Delaware Electric and Supply Company.*)

A deficiency for 1918 taxes based upon a waiver, pursuant to section 250 (d), act of 1921, which was signed after the statutory period had elapsed was disallowed. (B. T. A. decision 672, docket 2420, *Estate of Samuel Heinrich.*)

Any formula for determining the value of intangible property acquired must be based upon knowledge of the cost value of tangible property. (B. T. A. decision 673, docket 2506, *International Consolidated Chemical Company.*)

Reasonable salaries agreed to by all the directors and stockholders of a close corporation without formal action are deductible, though due to the book-keeper's failure to follow instructions, no book entries were made until the following year.

Unpaid salaries forgiven to a corporation may be included in invested capital only from the date of forgiveness. (B. T. A. decision 676, docket 583, *The Parisian.*)

Where a corporation holding seventy-five per cent of the stock of another has no control over the remaining shares, the two are not affiliated under the act of 1918. (B. T. A. 697, docket 1856, *Ditter Bros., Inc.*)

Amounts paid to stockholders who rendered no services are not allowable deductions. (B. T. A. decision 681, docket 1940, *Alexander Reid and Company.*)

A loss sustained by the cancellation of government contracts is deductible in computing taxable income from such contracts.

A return, incorrect by reason of an error made by an inexperienced book-keeper, is not a fraudulently false one made with intent to evade the income tax. (B. T. A. decision 687, docket 234, *Gutherman Strauss Company.*)

The value of an interest at the time of a decedent's death cannot be established by a statement showing an estimated deficit at a date several years subsequent thereto.

Balance-sheets, net earnings, dividends, existing surplus and capital stock tax valuation over a five-year period are more competent to show stock value than an isolated sale made six months prior to the valuation date. (B. T. A. decision 692, docket 1782, *Walter et al., Executors.*)

Taxpayer's failure to claim a deduction for depreciation of patents in his original return does not preclude the claiming of such deduction later. (B. T. A. decision 693, docket 1839, *S. Marsh Young.*)

A debt may not be deducted as worthless as long as the assets of the debtor will permit a recovery in part. (B. T. A. decision 698, docket 3021, *Equinox Company.*)

An objection to testimony of purely hearsay character as to the average rate of tax paid by representative corporations was sustained by the board. (B. T. A. decision 702, docket 2856, *Walker Creamery Products Company.*)

TREASURY RULINGS
(T. D. 3743, August 17, 1925)

ARTICLE 1008: Collection of tax by suit.

INTERNAL REVENUE TAXES—RECEIVERSHIP—DECISION OF COURT

An order of a state court requiring the filing of all claims in receivership on or before a certain date does not apply to the filing of a claim by the United States for unpaid taxes, as such a claim can be filed at any time while the receivership is pending and assets of the estate remain undistributed.

The following decision of the appellate court of the first district of Illinois in the case of *Reinecke, Collector, v. General Combustion Co., Insolvent*, is published for the information of internal-revenue officers and others concerned.

APPELLATE COURT OF ILLINOIS, FIRST DISTRICT
Reinecke, Collector, v. General Combustion Co., Insolvent

[June 9, 1925]

FITCH, presiding justice: This is an appeal from an order of the superior court directing the receiver in charge of the property of the General Combustion Co., an insolvent corporation, "to reject, disallow and disregard" the claim of appellant as collector of internal revenue for taxes alleged to be due to the United States.

The order recites that the matter came on to be heard in the superior court upon the petition of the receiver for instructions as to the disposition of the collector's claim, which was filed on July 14, 1923; that on June 24, 1922, an order was entered requiring all persons having claims against said corporation to file the same on or before August 1, 1922, which order also provided that "all persons, firms, or corporations" who shall fail to file their claims on or before August 1, 1922, should be forever barred from sharing in the property or assets of the corporation then in the possession of said court, and directed that a notice thereof be published for three weeks in some newspaper of general circulation published in Chicago, Ill.; that the receiver had published such a notice and had complied in all respects with such order; that the court being advised that the claim so made, if allowed and paid by the receiver, "would exhaust the assets" in the hands of the receiver, a request was made upon the collector "to show under the law the amount of tax due, or to submit an equitable basis of compromise authorized by the secretary of the treasury of the United States of America," and the disposition of the petition of the receiver for instructions was continued to afford time to the collector "to secure instructions and authority from the secretary of the treasury"; that more than 60 days had elapsed, and that said claimant "has failed to submit any proposition for the settlement of her claim."

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From the terms of this order, it would appear that the chancellor deemed the claim of appellant to be of such a doubtful character that he had suggested to the collector that she either "show under the law the amount of tax due" or submit an authorized equitable basis of compromise. But the record shows that the parties stipulated "that the only question at issue before the court in this cause and for appeal is an issue of law, to wit, whether or not in this, a receivership proceeding in the state court where the cause is still pending and the assets undistributed, the order . . . requiring all persons having claims against the General Combustion Co., insolvent, to file such claims on or before August 1, 1922, or else be forever barred from filing such claims, applies to the United States of America or the collector of internal revenue in case of a claim for federal taxes."

Such being the stipulation of the parties, the appellant has filed in this court only a praecipe record, containing certain orders and stipulations. This record shows that two claims were filed by appellant. The first was filed on June 13, 1923, and is a claim of the collector against the General Combustion Co., "bankrupt," for an alleged capital-stock tax assessed for the year 1922, under section 1000 of the revenue act of 1918, for \$100.80 and interest. As to this claim, the order appealed from makes no mention of it, and there is no stipulation concerning it except that such a claim was filed. The second claim was filed on July 14, 1923, and is a claim of the collector against said "bankrupt" for income taxes for the year 1918, levied under the revenue act of 1917, amounting to \$12,521.41 and interest; and it was stipulated that the tax appears in "the original income-tax assessment list for the month of June, 1923." This is the only claim mentioned in the order appealed from. It was further stipulated that no actual personal notice of the limitation order of June 24, 1922, was ever given to or served upon the collector, and that there has been no distribution of the assets of the insolvent corporation, but that the receiver has on hand the "sum of \$14,000 cash money," subject to distribution.

Under the stipulation, the question of the validity or amount of appellant's claim is not before us. The only question is whether the federal government is barred from asserting its claim against the assets in the hands of the receiver because its claim was not presented on or before August 1, 1922, as required by the previous order of the superior court. To this question there can be but one answer, and that in the negative.

"The principle that the United States are not bound by any statute of limitations nor barred by any laches of their officers, however gross, in a suit brought by them as a sovereign government to enforce a public right or to assert a public interest, is established past all controversy or doubt." (*U. S. v. Beebe*, 127 U. S., 338, 344.) "It is settled beyond doubt or controversy—upon the foundation of the great principle of public policy applicable to all governments alike, which forbids that the public interest should be prejudiced by the negligence of the officers or agents to whose care they are confided—that the United States, asserting rights vested in them as a sovereign government, are not bound by any statute of limitations, unless congress has clearly manifested its intention that they should be so bound. (*Lindsey v. Miller*, 6 Pet., 666; *U. S. v. Knight*, 14 Pet., 301, 315; *Gibson v. Chouteau*, 13 Wall., 92; *U. S. v. Thompson*, 92 U. S., 486; *Fink v. O'Neil*, 106 U. S., 272, 281 (4 Am. Fed. Tax Rep., 4600); *United States v. Nashville, Chattanooga & St. Louis Ry. Co.*, 118 U. S., 120.) No act of congress has been cited, and we know of none, in which a contrary intention is manifested.

While counsel for the government have covered a wide field in their brief, we are of the opinion that the above quotations are decisive as to the only question involved on this appeal. Counsel discuss the questions, whether state insolvency laws are suspended by the national bankruptcy act, whether the government is entitled to priority over the claims of other creditors, whether a notice by publication of such a limitation order is binding upon the government, and similar questions. None of these questions is pertinent to the stipulated question at issue on this appeal. However, as the stipulated extract from the "tax assessment list" is a meaningless jumble of figures,

when separated from its context and otherwise unexplained, and as neither the order appealed from, nor any other part of the praecipe record, shows that any evidence was heard, we deem it not wholly obiter for us to say that it is our understanding of the law that if the government has a valid claim against the insolvent corporation for unpaid taxes, its claim must be proved like any other claim, and if allowed, its claims will have priority over the claims of other creditors (*Union Trust Co. v. Ill. Midland Co.*, 117 U. S. 434; sec. 3466, U. S. Rev. Stat.); also, that it is the right of the federal government to present its claim for taxes at any time during the pendency of the receivership proceedings and before the assets are distributed. (*U. S. v. Birmingham Trust & Savings Co.*, 258 Fed. 562, 564.)

The suggestion contained in the order that the court might require the government to submit a proposition of settlement or compromise is clearly untenable. Section 3469 of the United States *Revised Statutes* authorizes the secretary of the treasury to compromise claims in favor of the United States, when recommended by the solicitor of the treasury, upon a report from a district attorney or any special attorney having charge of the claim. But we do not understand that it has ever been held that the court, by which a receiver has been appointed, may require the government, as a condition to either the filing or the allowance of its claims for taxes, to submit a proposition of settlement.

For the reasons stated, the order of the superior court is reversed and the cause remanded for further proceedings not inconsistent with the views herein expressed.

(T. D. 3744, August 17, 1925)

ARTICLE 836: Tangible property paid in: value in excess of par value of stock.
WAR PROFITS AND EXCESS PROFITS TAX—TANGIBLE PROPERTY PAID IN:
VALUE IN EXCESS OF PAR VALUE OF STOCK

Article 836, regulations 45 (1920 edition), and article 836, regulations 62, amended.

Article 836, regulations 45 (1920 edition), and article 836, regulations 62, are hereby amended to read as follows:

ART. 836. *Tangible property paid in: value in excess of par value of stock.*—EVIDENCE offered to support a claim for a paid-in surplus must be as of the date of the payment, and may consist among other things of (a) an appraisal of the property by disinterested authorities made on or about the date of the transaction; (b) certification of the assessed value in the case of real estate; and (c) proof of a market price in excess of the par value of the stock or shares. The additional value allowed in any case is confined to the value definitely known or accurately ascertainable at the time of the payment. No claim will be allowed for a paid-in surplus in a case in which the additional value has been developed or ascertained subsequently to the date on which the property was paid into the corporation. In all cases the proof of value must be clear and explicit.

(T. D. 3747, August 21, 1925)

ARTICLE 1009: Collection of tax by distraint.

TAKING SEIZED PROPERTY FROM CUSTODY OF INTERNAL REVENUE OFFICER—SECTION 71, CRIMINAL CODE—CHARGE TO JURY

1. Where property has been seized under warrant for distraint to satisfy an unpaid internal-revenue tax due by a corporate taxpayer, and a portion of the property so seized is removed by an officer of the corporation, on his own motion after the levy, his claim that the property removed belonged to him individually is inadequate as a defense when charged under section 71, *Criminal Code*, with dispossessing or receiving property taken or detained by an officer under the authority of a revenue law.

2. The words "rescue" and "dispossess" mean that where an article or person has been seized and taken into custody, the forcible or surreptitious taking of that article or that person out of the custody of the officer then a "rescue" has occurred.

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3. Leaving property in the possession of an individual after levy does not justify him in taking and disposing of it for his own purposes.

4. Where an individual has knowledge that a levy has been made, but in the face of it takes goods seized under a warrant for distraint, and on his own action, without an appeal to any court, disposes of them, he is guilty of violating the provisions of section 71, *Criminal Code*.

The following charge to the jury in the case of the *United States v. Frank C. Sauer*, given by the court in a trial recently had in the United States district court for the western district of Pennsylvania, is published for the information of internal-revenue officers and others concerned.

DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF
PENNSYLVANIA. No. 283—CRIMINAL

United States v. Frank C. Sauer

[May 5, 1925]

CHARGE OF THE COURT

GIBSON, J

GENTLEMEN OF THE JURY:

The defendant named in this indictment, Frank C. Sauer, is charged with having on the 22d day of December, 1922—between that date and the 29th of December, in the same year, unlawfully, knowingly, willfully, and feloniously, in a building located at No. 1039 East Ohio street, North Side, Pittsburgh, Pa., dispossessed and rescued certain property, to wit, five piles of hides, which are alleged to be of considerable value, which had been distrained by a deputy collector of internal revenue in the collection of a tax alleged to be due on the part of the Sauer Hide Co.

The government has introduced certain testimony to the effect of the assessment of a tax against the Sauer Hide Co. and the issue of warrant of distraint to the deputy collector of internal revenue, and service of that particular warrant of distraint. I shall not undertake to detail the manner of it; you will recollect his testimony in so far as the service is concerned. He is alleged to have given a copy of the list of articles seized by him to the defendant, and also to have posted the notices on the premises. A part of the property which was distrained by him, seized under his levy, according to the testimony offered by the government, was five piles of hides which were on the premises of this Sauer Hide Co., on East Ohio street, in the city of Pittsburgh. As we understand the testimony of the defendant, there is no denial of any of the testimony to the extent to which we have detailed it. That will be for your recollection, however, gentlemen of the jury.

The defense is one which to the court seems inadequate, under the present circumstances, to the effect that the defendant was the owner of the stuff seized, that is, of this particular amount of hides, five piles of hides, and claimed individual ownership of them. Under the circumstances, as detailed, as we have stated before, the court has excluded evidence of that particular defense. You are to determine here whether the government has established beyond a reasonable doubt that on or about the particular date charged in the indictment, within the western district of Pennsylvania, the deputy collector of internal revenue had distrained upon and levied upon five piles of hides, which have been mentioned in the evidence here, and whether or not this defendant rescued or dispossessed the collector of those hides. Now, the words "rescued" and "dispossess" simply mean that where an article or a person has been seized and taken into the custody of the law, if anyone forcibly or surreptitiously takes those articles or that particular person out of the custody of the officer, then a rescue has occurred. You are to determine here whether or not this defendant has taken, without lawful authority, the five piles of hides after they had been levied upon. Now, the mere fact that they were left in possession would not in any way justify his taking those goods and disposing of them for his own purpose. If you are satisfied beyond a reasonable doubt that the levy was made and served upon him, and that he knowing the existence of that levy, in the face of it, took those hides and disposed of them, without any appeal

to any court, but upon his own motion, then your verdict in this case should be guilty as indicted. If you are not so satisfied, under the evidence, your verdict should be not guilty. You will, in passing upon that, however, determine whether or not there is any evidence which would tend to contradict any of the particular matters which have been alleged here in support of the indictment.

The defendant by his counsel has submitted a point to the court and has requested us to charge the jury in accordance with it. We have refused that point, and do not read it.

You will take the case, gentlemen.

(T. D. 3748, August 31, 1925)

Income tax—Association distinguished from trust

Article 1504 of Regulations 65 is hereby amended to read as follows:

ART. 1504. *Association distinguished from trust.*—Where trustees merely hold property for the collection of the income and its distribution among the beneficiaries of the trust, and are not engaged, either by themselves or in connection with the beneficiaries, in the carrying on of any business, and the beneficiaries have no control over the trust although their consent may be required for the filling of a vacancy among the trustees or for a modification of the terms of the trust, no association exists, and the trust and the beneficiaries thereof will be subject to tax as provided by section 219 and by articles 341-347. If, however, the beneficiaries have positive control over the trust, whether through the right periodically to elect trustees or otherwise, an association exists within the meaning of section 2. Even in the absence of any control by the beneficiaries, where the trustees are not restricted to the mere collection of funds and their payment to the beneficiaries, but are associated together with similar or greater powers than the directors in a corporation for the purpose of carrying on some business enterprise, the trust is an association within the meaning of the statute.

(T. D. 3749, August 31, 1925)

Income Tax—Association

Article 1502 of regulations 65 is hereby amended to read as follows:

ART. 1502. *Association.*—Associations and joint-stock companies include associations, common-law trusts, and organizations by whatever name known, which act or do business in an organized capacity, whether created under and pursuant to state laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the shareholders on the basis of the capital stock which each holds, or, where there is no capital stock, on the basis of the proportionate share or capital which each has or has invested in the business or property of the organization. A corporation which has ceased to exist in contemplation of law but continues its business in quasi-corporate form is an association or corporation within the meaning of section 2.

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EDITED BY H. A. FINNEY

ASSISTED BY H. P. BAUMANN

ANALYSIS OF STATEMENTS

It is desired in this article to show that an analysis of the financial condition of a company for credit purposes cannot be adequate if it is based upon a single balance-sheet of the company under consideration; that if the analysis is supplemented by a scrutiny on the profit-and-loss statement of the concern for a single year there is still a danger that many significant facts may not be brought to light; and that, in order to make an adequate investigation of the financial condition and income-producing power of the prospective borrower, the analyst should have at hand at least two balance-sheets and at least two statements of income and profit and loss.

By way of illustration of this contention the following statement and comments are submitted. The analysis of the balance-sheet as of December 31, 1924, and of the income statement of the year ended at that date will indicate a satisfactory condition; but the analysis which is made possible by the comparison of this balance-sheet with one of an earlier date and by the comparison of the income for the year 1924 with that for the preceding year will disclose a general tendency of an unfavorable nature.

It is recognized that the following statements are somewhat condensed and that they do not show many items which would appear in the actual statements of a manufacturing concern, but they have been purposely abbreviated in order to eliminate all unessential data and to permit concentration upon the essential facts required for the analysis. Following is the balance-sheet of the concern under investigation as of December 31, 1924, and this balance-sheet is assumed to be the latest one available.

THE BLANK COMPANY

Balance-sheet—December 31, 1924

ASSETS

Current assets:

Cash.....	\$15,000.00	
Accounts receivable.....	\$106,000.00	
Less—reserve for doubtful ac- counts.....	3,000.00	103,000.00

Inventories:

Raw materials.....	\$30,000.00	
Goods in process.....	18,000.00	
Finished goods.....	135,000.00	183,000.00
		<u>\$301,000.00</u>

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<i>Fixed assets:</i>			
Land.....		\$20,000.00	
Buildings.....	\$195,000.00		
Less—reserve for depreciation.	30,000.00	165,000.00	
Machinery and equipment.....	\$86,000.00		
Less—reserve for depreciation.	12,000.00	74,000.00	259,000.00
<i>Deferred charges:</i>			
Insurance premiums—unexpired portion.....			300.00
Total.....			<u>\$560,300.00</u>

LIABILITIES

<i>Current liabilities:</i>			
Accounts payable.....	\$75,000.00		
Notes payable.....	50,000.00	\$125,000.00	
<i>Fixed liabilities:</i>			
First mortgage, 6%, bonds payable.....			50,000.00
<i>Capital:</i>			
Capital stock.....	\$250,000.00		
Surplus—			
January 1, 1924.....	\$119,200.00		
Net Profit for the year.....	31,100.00		
Total.....	\$150,300.00		
Less—dividends paid.....	15,000.00		
Balance—December 31, 1924.....		135,300.00	385,300.00
Total.....			<u>\$560,300.00</u>

An examination of this balance-sheet shows that the current assets are over \$300,000, while the current liabilities are \$125,000, making a current asset ratio of approximately $2\frac{1}{2}$ to 1. The cash and accounts receivable are nearly equal to the accounts payable and notes payable. The fixed liabilities of \$50,000 are very small in comparison with the fixed assets. The net profit of \$31,100 is approximately 12% of the capital stock, and is nearly 9% of the capital stock and surplus of January 1, 1924. The company has thus been able to pay a 6% dividend on its stock and add about \$16,000 to its surplus during the year.

The balance-sheet does not indicate, however, whether the cash balance of \$15,000 is adequate to meet the current cash requirements. It does not contain any information by which the currency of the accounts receivable can be determined; it does not give any indication as to whether the inventories are

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inadequate or excessive; and it does not furnish any information by which to judge whether the current liabilities are being promptly paid.

Some further information could be obtained by an examination of the income statement for the year 1924, but we shall proceed immediately to submit the balance-sheets at two successive dates and the income statements for two successive years. The analysis which will be based upon these statements will indicate what methods of analysis are available when the information shown by the balance-sheet and an income statement can be correlated.

Exhibit "A"

THE BLANK COMPANY

Balance-sheets—December 31, 1924 and 1923, and comparison

ASSETS	Year ended December 31,		Increase or Decrease*
	1924	1923	
<i>Current assets:</i>			
Cash.....	\$15,000.00	\$40,000.00	\$25,000.00*
Accounts receivable.....	106,000.00	74,000.00	32,000.00
Less—reserve for doubtful ac- counts.....	3,000.00	3,000.00	.....
Remainder—book value.....	\$103,000.00	\$71,000.00	\$32,000.00
Inventories:	-		
Raw materials.....	\$30,000.00	\$25,000.00	\$5,000.00
Goods in process.....	18,000.00	13,000.00	5,000.00
Finished goods.....	135,000.00	110,000.00	25,000.00
Total inventories.....	\$183,000.00	\$148,000.00	\$35,000.00
Total current assets.....	\$301,000.00	\$259,000.00	\$42,000.00
<i>Fixed assets:</i>			
Land.....	\$20,000.00	\$20,000.00	\$.....
Buildings.....	\$195,000.00	\$130,000.00	\$65,000.00
Less—reserve for depreciation..	30,000.00	20,000.00	10,000.00
Remainder—depreciated value.....	\$165,000.00	\$110,000.00	\$55,000.00
Machinery and equipment.....	\$86,000.00	\$65,000.00	\$21,000.00
Less—reserve for depreciation..	12,000.00	10,000.00	2,000.00
Remainder—depreciated value.....	\$74,000.00	\$55,000.00	\$19,000.00
Total fixed assets.....	\$259,000.00	\$185,000.00	\$74,000.00

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<i>Deferred charges:</i>			
Insurance premiums—			
Unexpired portion	\$300.00	\$200.00	\$100.00
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Total	\$560,000.00	\$444,200.00	\$116,100.00
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LIABILITIES			
<i>Current liabilities:</i>			
Accounts payable	\$75,000.00	\$50,000.00	\$25,000.00
Notes payable	50,000.00	45,000.00	5,000.00
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Total current liabilities	\$125,000.00	\$95,000.00	\$30,000.00
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<i>Fixed liabilities:</i>			
First mortgage, 6%, bonds payable	\$50,000.00	\$30,000.00	\$20,000.00
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<i>Capital:</i>			
Capital stock	\$250,000.00	\$200,000.00	\$50,000.00
Surplus, per exhibit "B"	135,300.00	119,200.00	16,100.00
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Total capital	\$385,300.00	\$319,200.00	\$66,100.00
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Total	\$560,300.00	\$444,200.00	\$116,100.00
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Exhibit "B"

THE BLANK COMPANY

Summary of profit and loss and surplus for the years ended December 31, 1924 and 1923, and comparison

PARTICULARS	Year ended December 31,		Increase or Decrease*
	1924	1923	
Gross sales	\$862,000.00	\$828,000.00	\$34,000.00
Returned sales and allowances	12,000.00	8,000.00	4,000.00
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Net sales	\$850,000.00	\$820,000.00	\$30,000.00
Cost of goods sold (schedule No. 1)	595,000.00	557,600.00	37,400.00
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Gross profit on sales	\$255,000.00	\$262,400.00	\$7,400.00*
Selling expenses (schedule No. 2)	148,000.00	132,000.00	16,000.00
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Net profit on sales	\$107,000.00	\$130,400.00	\$23,400.00*
General expenses (schedule No. 3)	76,000.00	94,250.00	18,250.00*
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Net profit on operations	\$31,000.00	\$36,150.00	\$5,150.00*
Net financial expenses (schedule No. 4)	400.00	250.00	150.00
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Net profit for the year	\$30,600.00	\$35,900.00	\$5,300.00*
Surplus at beginning of the year	119,200.00	95,400.00	23,800.00
Surplus credits (schedule No. 5)	1,200.00	850.00	350.00
Gross surplus	\$151,000.00	\$132,150.00	\$18,850.00
Surplus charges:			
Miscellaneous losses, etc. (schedule No. 6)	700.00	950.00	250.00*
Dividends	15,000.00	12,000.00	3,000.00
Total surplus charges	\$15,700.00	\$12,950.00	\$2,750.00
Surplus at end of the year	\$135,300.00	\$119,200.00	\$16,100.00

Exhibit "C"

THE BLANK COMPANY

Statement of cost of goods manufactured and goods sold for the years ended December 31, 1924 and 1923, and comparison

PARTICULARS	Year ended December 31,		Increase or Decrease*
	1924	1923	
<i>Materials:</i>			
Inventory, beginning of the year ..	\$25,000.00	\$20,000.00	\$5,000.00
Purchases	185,000.00	177,000.00	8,000.00
Total	\$210,000.00	\$197,000.00	\$13,000.00
Inventory, end of the year	30,000.00	25,000.00	5,000.00
Materials used	\$180,000.00	\$172,000.00	\$8,000.00
Direct labor	225,000.00	213,000.00	12,000.00
Manufacturing expenses (statement No. 1)	220,000.00	194,600.00	25,400.00
Total	\$625,000.00	\$579,600.00	\$45,400.00
Goods in process, beginning of the year..	13,000.00	11,000.00	2,000.00
Total	\$638,000.00	\$590,600.00	\$47,400.00
Goods in process, end of the year	18,000.00	13,000.00	5,000.00
Remainder—cost of goods manufactured	\$620,000.00	\$577,600.00	\$42,400.00
Finished goods—beginning of the year..	110,000.00	90,000.00	20,000.00
Total	\$730,000.00	\$667,600.00	\$62,400.00
Finished goods—end of the year	135,000.00	110,000.00	25,000.00
Remainder—cost of goods sold	\$595,000.00	\$557,600.00	\$37,400.00

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Some of the supporting schedules and statements referred to in the foregoing statements are not included in this article as they would require considerable space without adding greatly to the analysis.

We are now in a position to make a comparison of the financial condition at December 31, 1923, with that at December 31, 1924, using for this purpose the data shown in the comparative balance-sheet. While the various items of assets and liabilities can be compared by direct examination of the comparative balance-sheet, it is thought that the re-assembling of these figures in a statement of application of funds will assist in disclosing significant facts and relationships.

THE BLANK COMPANY

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

Funds provided:

By profits:		
Net profit—per exhibit "B".....	\$30,600.00	
Add—surplus credits and charges (net).....	500.00	
Depreciation (which decreased profits without reducing funds provided thereby):		
Machinery and equipment.....	2,000.00	
Buildings.....	10,000.00	
Total.....		\$43,100.00
By additional issue of bonds.....		20,000.00
By additional issue of stock.....		50,000.00
Total funds provided.....		<u>\$113,100.00</u>

Funds applied:

Payment of dividend.....		\$15,000.00
Addition to fixed assets:		
Buildings.....	\$65,000.00	
Machinery and equipment.....	21,000.00	
Total.....		\$86,000.00
Increase in working capital and deferred charges, Per schedule No. 1.....		\$12,100.00
Total funds applied.....		<u>\$113,100.00</u>

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THE BLANK COMPANY

Schedule of working capital and deferred charges for the year ended December 31, 1924

	December 31, 1924	1923	Increase or Decrease*
<i>Current assets:</i>			
Cash.....	\$15,000.00	\$40,000.00	\$25,000.00*
Accounts receivable—net.....	103,000.00	71,000.00	32,000.00
Inventories.....	183,000.00	148,000.00	35,000.00
	<u>\$301,000.00</u>	<u>\$259,000.00</u>	<u>\$42,000.00</u>
<i>Current liabilities:</i>			
Accounts payable.....	\$75,000.00	\$50,000.00	\$25,000.00
Notes payable.....	50,000.00	45,000.00	5,000.00
	<u>\$125,000.00</u>	<u>\$95,000.00</u>	<u>\$30,000.00</u>
<i>Working capital</i>	<u>\$176,000.00</u>	<u>\$164,000.00</u>	
Ratio.....	<u>2.4 to 1</u>	<u>2.7 to 1</u>	
Increase in working capital.....			\$12,000.00
Increase on deferred charges.....			100.00
Increase in working capital and deferred charges.....			<u>\$12,100.00</u>

The statement of application of funds shows that the profit of the concern before provision for depreciation brought into the business funds amounting to \$43,100; but in order to provide for the expenditures made by the company during the year, it appears to have been necessary to increase both the bond and stock issues. The funds thus made available were used for the payment of dividends, for additions to fixed assets, and for a slight increase in the working capital.

The question as to the profitableness of the additional investment in the fixed assets will be considered later, but attention will first be given to a comparison of the relative net current asset condition at the two dates as shown by the schedule of working capital. It will be noticed that the cash has decreased very considerably, that the accounts receivable and inventories have considerably increased and that the current liabilities in the form of accounts and notes have also increased. While the working capital has increased \$12,000, it is significant that the ratio has decreased, the ratio at the end of 1923 being 2.7 to 1, and the ratio at the end of 1924 being 2.4 to 1. As the actual working capital stated in dollars is rather less significant than the working capital ratio, it appears that the current position is not as favorable as it was.

This analysis of the working-capital position can be carried further by an examination of the relative currency or liquidity of the current assets. It has been seen that at the end of 1924 there were fewer dollars of current assets per

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dollars of current liabilities than at December 31, 1923. It is significant to note further that the current assets at the latter date are relatively less current than they were at the earlier date as shown by the following summary.

Relative Liquidity of Current Assets

	December 31, 1924		December 31, 1923	
	Amount	Ratio to Total	Amount	Ratio to Total
Cash.....	\$15,000.00	5.0%	\$40,000.00	15.4%
Accounts receivable—net.....	103,000.00	34.2	71,000.00	27.4
Finished goods.....	135,000.00	44.8	110,000.00	42.5
Goods in process.....	18,000.00	6.0	13,000.00	5.0
Raw materials.....	30,000.00	10.0	25,000.00	9.7
Total.....	\$301,000.00	100.0%	\$259,000.00	100.0%

By reference to the foregoing summary it will be noticed that at the end of 1923 the cash represented over 15% of the total current assets, while at the end of 1924 it represented only 5%. This decrease in the highly current asset of cash has been offset by increases in the last current assets of accounts receivable and inventories. Thus it appears that while the current liabilities have increased during the year the ratio of current assets and current liabilities has decreased, and the current assets are relatively less current than they were at the close of the preceding year.

As it is necessary to sell merchandise before it can be made available for current liability payments, it is significant to omit the inventories from the current assets and to note the ratio of the cash and the accounts receivable to the current liabilities.

Cash and Receivables to Payables

	December 31,	
	1924	1923
Cash.....	\$15,000.00	\$40,000.00
Accounts receivable—net.....	103,000.00	71,000.00
Total.....	\$118,000.00	\$111,000.00
Accounts payable.....	\$75,000.00	\$50,000.00
Notes payable.....	50,000.00	45,000.00
Total.....	\$125,000.00	\$95,000.00
Ratio.....	.94 to 1	1.17 to 1

The foregoing comparative summary shows an increase of only \$7,000 in the cash and accounts receivable with an increase of \$30,000 in the accounts and notes payable. This results in a very considerable decrease in the ratio.

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Since the accounts receivable have increased from \$71,000 to \$103,000, it will be pertinent to inquire whether this increase has resulted from an increase in the volume of business or whether it has resulted from a slowing up of collections.

Light is thrown upon these questions by the following statement.

Accounts Receivable Collection Turnover

	Year ended December 31,	
	1924	1923
Net sales	\$850,000.00	\$820,000.00
Accounts receivable—gross	\$106,000.00	\$74,000.00
Ratio to net sales	12.47%	9.02%
Multiply by (days)	365	365
Accounts receivable collection turnover	46 (days)	33 (days)

The foregoing summary shows that the gross value of the accounts receivable has increased \$32,000 although the net sales increased only \$30,000. The accounts receivable at the end of 1923 represented about 9% of the year's sales, while the accounts receivable at the end of 1924 represented about 12½% of the year's sales. Assuming that there was a uniform business throughout the year, the accounts receivable at the end of 1924 represent the business of about a month and a half, while the account receivable at the end of 1923 represented the business of about a month.

The schedule of working capital submitted in connection with the statement of application of funds showed an increase in the inventory as well as in the accounts receivable. We have noted that the increase in the accounts receivable did not appear to be a healthy one; let us now make a similar investigation of the increase in the finished goods inventory by comparing the finished-goods turnover for the two years.

Finished-goods Turnover

	Year ended December 31,	
	1924	1923
Cost of goods sold	\$595,000.00	\$557,600.00
Finished-goods inventory:		
January 1	\$110,000.00	\$90,000.00
December 31	135,000.00	110,000.00
Total	\$245,000.00	\$200,000.00
Average	\$122,500.00	\$100,000.00

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Turnover:

Times per annum.....	4.85	5.58
Average days each turnover—(365 divided by times per year).....	75 (days)	65 (days)

This analysis shows that in 1923 the finished goods were turned about 5½ times while in 1924 they were turned only about 4¾ times. Or stated in another way, in 1923 the finished goods were turned every 65 days whereas in 1924 75 days were required.

It will now be interesting to combine the finished-goods turnover figures with the accounts-receivable turnover figures.

Time Required for Conversion of Finished-goods Inventory into Cash

	Year ended December 31,	
	1924	1923
Days required to sell inventory.....	75	65
Days required to collect accounts.....	46	33
Total.....	121	98

The foregoing figures indicate that during 1923 it took an average of 65 days to convert the inventory to accounts receivable and 33 days to convert the account receivable into cash, or a total of 98 days to convert the finished-goods inventory into cash. In 1924 this process required 121 days.

The scrutiny of the receivables and the inventories indicates that with the increase in current liabilities there has come a decrease in the liquidity of the current assets with which the liabilities will have to be paid. This decrease in the liquidity of current assets may be expected to result in a slowing up of the process of paying the current liabilities. This slowing-up process is to some extent indicated by the increase in the current liabilities. It is further indicated in the following statement showing the ratio of the current liabilities to purchases.

Ratio of Current Liabilities to Purchases

	Year ended December 31,	
	1924	1923
Purchases.....	\$185,000.00	\$177,000.00
Accounts payable.....	\$75,000.00	\$50,000.00
Ratio to purchases.....	40.1%	28.2%
Days' purchases unpaid— (365 x per cents).....	146	103
Notes payable.....	50,000.00	45,000.00
Total.....	\$125,000.00	\$95,000.00
Ratio to purchases.....	67.6%	53.7%

This analysis shows that the accounts payable at the end of 1923 represented 28% of the year's purchases or on the average they represented unpaid pur-

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chases for 103 days; the accounts payable at the end of 1924 were 40% of the year's purchases or on the average the purchases for 146 days were unpaid. If we include the notes payable it appears that at the end of 1923, 53% of the year's purchases were unpaid, and that at the end of 1924, 67% were unpaid.

Summarized, we find that while there has been a slight increase in actual working capital, the working-capital ratio has decreased, the current assets are relatively less current than they were at the close of the preceding year because of the considerable swing from cash to receivables and inventories; that the receivables are collected with less promptness than heretofore, that the inventories do not turn as rapidly as they did, and that the accounts and notes payable consequently are not being paid with the same promptness that prevailed in 1923.

So much for the current assets and current liabilities. Let us now note the increases which have been made in the fixed assets and see whether the increased investment has been made productive.

Increases in Plant, Production, Etc.

	December 31,		Increase	
	1924	1923	Amount	Per Cent
Buildings	\$195,000.00	\$130,000.00	\$65,000.00	50%
Machinery and equipment	86,000.00	65,000.00	21,000.00	32%
<hr/>				
Material used	\$180,000.00	\$172,000.00	\$8,000.00	5%
Labor	225,000.00	213,000.00	12,000.00	6%
Manufacturing expense	220,000.00	194,600.00	25,400.00	13%
Finished goods manufactured	620,000.00	577,600.00	42,400.00	7%
Cost of goods sold	595,000.00	557,600.00	37,400.00	6%
<hr/> <hr/>				

It will be noted that the investment in buildings has increased 50% and the investment in machinery and equipment has increased 32%. Has the increase in production kept pace with the increase in plant facilities? It appears from the foregoing analysis that with a 50% increase in buildings and a 32% increase in machinery and equipment the concern has used only 5% more material and 6% more labor. The manufacturing expenses, however, because of the increase in the fixed-asset investment, have increased 13%. Only 7% more finished goods have been manufactured and only 6% more goods have been sold. This analysis should be qualified, however, by a statement to the effect that there is no information as to the date when the additional plant was put into operation.

Let us now turn from a comparison of the financial conditions to a comparison of the profits for the two years [see next page].

This statement shows that while the net sales have increased only 3 $\frac{1}{2}$ % the cost of goods sold has increased 6 $\frac{1}{4}$ % with the result that the rate of gross profit has decreased almost 3%. It is also significant to note that in order to sell 3.66% more goods it has been necessary to incur 12.12% more selling expenses. The result of the increase in the rate of gross profit and the increase in the rate of selling expense has been a decrease of nearly 18% in the rate of

STATEMENT OF PROFIT AND LOSS—WITH PERCENTAGE ANALYSIS

	Year ended		December 31, 1923 Amount	Ratio to net sales	December 31, 1924 Amount	Ratio to net sales	Increase or Decrease* Amount	Ratio to 1923
	December 31, 1924	December 31, 1923						
	Amount	Ratio to net sales						
Gross sales.....	\$862,000.00	101.41%	\$828,000.00	100.98%	\$34,000.00	4.11%		
Returned sales and allowances.....	12,000.00	1.41	8,000.00	.98	4,000.00	50.00		
Net sales.....	\$850,000.00	100.00%	\$820,000.00	100.00%	\$30,000.00	3.66%		
Cost of goods sold.....	595,000.00	70.00	557,600.00	68.00	37,400.00	6.71		
Gross profit.....	\$255,000.00	30.00%	\$262,400.00	32.00%	\$7,400.00*	2.82%*		
Selling expenses.....	148,000.00	17.41	132,000.00	16.10	16,000.00	12.12		
Net profit on sales.....	\$107,000.00	12.59%	\$130,400.00	15.90%	\$23,400.00*	17.94%*		
General expenses.....	76,000.00	8.94	94,250.00	11.49	18,250.00*	19.36%*		
Net profit on operations.....	\$31,000.00	3.65%	\$36,150.00	4.41%	5,150.00*	14.25%*		

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net profit on sales. This decrease of net profit on sales has been compensated to some extent by a decrease in the rate of general expenses, but it is to be noted that although the nets sales have increased \$30,000 the net profit on operations has decreased over \$5,000 or a decrease of 14¼%. The increase in the capital stock and the decrease in the net profit on operations should be considered together.

Ratio of Net Profit to Capital

Capital at beginning of year (assuming \$50,000 additional stock issued at beginning of 1924):		
Capital stock.....	\$250,000.00	\$200,000.00
Surplus (per exhibit "B").....	119,200.00	95,400.00
	\$369,200.00	\$295,000.00
Net profit on operations.....	\$31,000.00	\$36,150.00
	8.4%	12.2%

There is no information as to the date when the \$50,000 par value of additional stock was issued, but if it is assumed that this stock was issued at the beginning of 1924, it appears that during 1923 the company made 12% profit on its capital stock and surplus (that is to say on its total investment) while in 1924 it made only 8.4%.

Correspondence

AN ANSWER EXPLAINED

Editor, The Journal of Accountancy:

SIR: I have received from you several letters criticising my answer to question 13 of the May, 1925, examination. That answer was published in the August issue of THE JOURNAL OF ACCOUNTANCY. These criticisms show careful consideration of the question by the persons who make them, and I think it is therefore advisable for me to say something further about this question.

The question was as follows:

"No. 13. A purchased an apartment house in 1921. A never received any income from the property; in fact, it never produced sufficient revenue to pay for the cost of running it. He sold the property in 1924 at a price lower than that he paid for it. You are called upon to prepare A's income-tax return for 1924. Upon examining his returns for prior years, you find that no depreciation was ever deducted by A in regard to the apartment house property, A explaining that as there was no income from the property to serve as the basis of a reserve fund for depreciation, he had never taken any. How would you compute A's loss on the sale and should any action be taken with reference to the returns for prior years?"

My answer was as follows:

"No. 13. Depreciation does not depend on income. Amended returns should be made for prior years taking depreciation as a deduction. In computing the loss the purchase price should first be reduced by depreciation from 1921 to 1924."

The critics of the answer call attention to the fact that while my answer was probably correct under earlier laws, the revenue act of 1924 provided in section 202 (b):

"In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for . . . any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, *previously allowed* with respect to such property."

Referring to the question, they believe that since the depreciation in question was not taken by the taxpayer, and therefore obviously was not allowed by the bureau previous to the sale in 1924, it should not be considered in computing the gain or loss.

They say that regulations 62, article 1561, contemplated proper adjustment for "any depreciation or depletion sustained and allowable as a deduction", and that the use of the word "allowed" in the act of 1924 indicated an intent to change the prior construction of the bureau.

It is my belief that the words "previously allowed" in the revenue act of 1924 will be construed to mean previously allowed by law and not simply previously allowed by the commissioner, as is assumed by the critics of the answer. My reasons for this are as follows:

1. It seems to me improbable that the law will be construed to allow a taxpayer not to take depreciation and thus create or increase a loss in a year when he may desire to have a loss. A construction which brought about such a result certainly would not be favored by the courts.

Correspondence

2. The construction limiting the adjustments to depreciation actually allowed by the bureau would eliminate depreciation for all previous years where the returns had not in fact been audited and settled. As the bureau usually is necessarily several years late in auditing returns, this would, in the ordinary case, exclude a large amount of depreciation, which would appear to be an unreasonable construction of the act. There is nothing in the act which indicates that there might be any middle ground of taking into consideration depreciation to the extent that it had been allowed in auditing the returns and to the extent that it had been claimed in unaudited returns.

3. The provision contained in section 202 (b) was not to be found in the revenue act of 1921. Before 1924, it was simply a matter of regulation. It is very clear in regulations 62, article 1561, already quoted, that any depreciation sustained and *allowable* was to be taken into consideration in determining gain and loss (the critics of the answer agree as to this). Unless, therefore, there is some indication that the revenue act of 1924 was intended to change the previous ruling of the bureau, the answer is correct.

4. No suggestion has been given of any reason why section 203 (b) of the revenue act of 1924 should be considered to change the prior ruling, except that new words, to wit, "previously allowed", have been used. I believe that a construction of these words as meaning previously allowed by the law is just as reasonable as to construe them to mean previously allowed by the bureau.

5. On the other hand, it appears that there was no intention on the part of congress to change the construction of the bureau under the revenue act of 1921 and earlier acts. It is true that the bill as originally introduced in the house of representatives contained the words "properly chargeable" instead of "previously allowed," and the bill as submitted by the committee on ways and means continued to use the words "properly chargeable." The report of the committee, however, was as follows (68th congress, first session, *H. R. Report No. 179*, page 12):

"(2) There is no provision in the existing law which corresponds to subdivision (b), but the rule laid down therein is substantially the same as the construction placed upon the existing law by the treasury department. It provides that in computing gain or loss from the sale or other disposition of property the cost or other basis of the property (and in the appropriate case the fair market value as of March 1, 1913) shall be increased by the amount of items *properly chargeable* to capital account and decreased by the depreciation and similar deductions allowed with respect to the property. Under this provision capital charges, such as improvements, and betterments, and carrying charges, such as taxes on unproductive property, are to be added to the cost of the property in determining the gain or loss from its subsequent sale, and items such as depreciation and obsolescence *previously allowed* with respect to the property are to be subtracted from the cost of the property in determining the gain or loss from its subsequent sale."

It should be noted that the committee report uses the words "properly chargeable" and "previously allowed" interchangeably. The bill passed the house with the words "properly chargeable." By senate amendment, these words were changed to "previously allowed." The senate report, however, 68th congress, first session, *Senate Report No. 398*, page 13, did not contain any language which indicated that there was an intention to change the prior construction of the bureau or the meaning of the language used by the house as

interpreted by the house committee. Apparently, the senate committee believed that "previously allowed" was a clearer expression than "properly chargeable". The report in part was as follows:

"(2) There is no provision in the existing law which corresponds to subdivision (b). It provides that in computing gain or loss from the sale or other disposition of property the cost or other basis of the property shall be increased by the cost of capital improvements and betterments made to the property since acquisition and decreased by the depreciation and similar deductions previously allowed with respect to this property. To remove a possible ambiguity in the house bill, the deductions are limited to those 'previously allowed' rather than those 'properly chargeable.'"

6. The report does not say what this "possible ambiguity" was, but it is easy to find an ambiguity in the words "properly chargeable." "Loss, exhaustion, wear and tear, obsolescence, amortization and depletion" were all words which had a statutory meaning as deductions allowed, but many of these words had also a broader meaning in accountancy. Particularly under the earlier statutes there were instances of losses and depletion, which would be "properly chargeable" under good accounting practice, but which would not be "allowed" by the revenue laws. The provision for deductions which were "previously allowed" rather than those which were "properly chargeable" seems to tie up the section to the other provisions of the revenue acts rather than to accounting principles generally.

7. Since it must be admitted that the earlier construction of the bureau took into consideration depreciation which was allowable, and since apparently congress had no intention to change this construction, it seems to follow that under the revenue act of 1924 depreciation which is allowable by the bureau, or allowed by law, should be taken into consideration in determining gain or loss.

8. Now, looking at the question from another point of view, there is nothing in it that says that the taxpayer's returns for 1921-1923 have been audited and finally settled. It would seem to me that as soon as the bureau became aware of the whole story from 1921 to 1924, it would of its own motion allow the taxpayer depreciation up to the sale and would reduce the loss by the depreciation so allowed thus effecting the same result.

Yours truly,

SPENCER GORDON.

Washington, D. C., September 14, 1925.

Book Reviews

RETAIL BUYING, by NORRIS A. BRISCO and JOHN W. WINGATE. *Prentice-Hall, Inc.*, New York. Cloth, 388 pages.

It is a far cry from the general store of the past to the department store of the present. Not long ago the merchant in the community was looked down upon because of the feeling that a man did not become a merchant if he could earn his living in a more dignified manner, that is, by practising a profession. Today, however, the situation is far different. The merchant is highly respected and is usually one of the leading men in his locality. This change in the status of the merchant has been accompanied by the development of scientific principles of merchandising. The publication of the "Retailing Series," of which *Retail Buying* is a part, is a result of this development. The series has been written principally to fill pedagogical requirements. The text of each chapter is followed by problems relative to that phase of the subject which has just been presented.

This book, although for use principally in the classroom, will without question interest all those associated with department stores in a buying or executive capacity. Accountants may also read this volume with profit, particularly the chapters on invoice procedure and control, mark-up, mark-down and the remarking of merchandise, inventory methods and stock control.

The study of retailing practices and principles has resulted in many discoveries and the presentation of these discoveries helps to make this book interesting. It has been found, for instance, that the trend of customer traffic is to the right from the entrance. Therefore, the display on the left is made more attractive than that on the right thus drawing customers to the left and avoiding congestion in aisles. Possibly some of us have never realized that pricing an article at ninety-eight cents instead of one dollar not only induces the customer to buy but also helps to prevent dishonesty on the part of salespeople. This is because the customer will in all probability present a dollar bill thus making it necessary for the salesman to write out a sales slip and make change.

W. B. FRANKE.

COMPLETE PRACTICAL INCOME TAX, by A. G. MCBAIN. *Gee and Company, Ltd.*, London.

Here is a book about the income-tax laws of Great Britain, written in a language not only easily comprehensible to an accountant but so devoid of technical language as to be readily understood by anyone who has tax problems. After an examination of the book's contents it is not difficult to agree with the author in the claim that "this book meets the whole practical requirement of final examination students . . . and also of the practising accountant and business man."

The subject is treated concisely, clearly and in a comprehensive manner; there are many examples setting forth the solutions of individual problems, which give life to what otherwise would be merely abstract dicta. In addition, the book is written to instruct those who must be interested in the subject, and, unlike other no less valuable contributions upon the subject, this one ap-

proaches taxation from the standpoint of the taxpayer and shows him how to meet his individual problems. It is worthy of note that so much of value can be compressed into a book of about two hundred and fifty pages. To those whose interest in income taxes is such that a comparison of the finance acts of the United Kingdom with the several revenue acts of our own country will be instructive this book will have a strong appeal.

STEPHEN G. RUSK.

HOW TO READ A FINANCIAL STATEMENT, by HERBERT G. STOCKWELL. *Ronald Press Company*, New York.

A right preface has some resemblance to a good character—a sure guidepost of content in the one case as of conduct in the other. The author there asserts his purposes and, barring verbiage, the reviewer has little more to do than to attest accomplishment or point out shortcomings. If Mr. Stockwell will pardon paraphrase of his preface in an attempt to repeat its essence it might be put thus:

- I. Every business man should know how to read not only his own financial statement but that of other concerns as well, for as creditor, banker, investor or what not he is equally interested in theirs.
- II. The main purpose of the book is (a) to enable the business man to do this, or failing that, (b) to know wherein the statement is not trustworthy.
- III. There being no standard model of financial statement the book deals with the varying forms actually in use.

Digesting that, what other conclusion could the thinking mind come to than that "all sorts of statements are presented"? "I comprehend my own, of course, but it behooves me to be able to understand others, or at least to discern if they are worthy of belief."

So much was written before a word of the book had been read, and then, having in mind its purpose, the attitude of the inquiring reader seeking enlightenment on various assumed obscurities and ambiguities was taken, with this outcome—that the chapter headings furnish an adequate guide to the general subject; that the paragraph headings running through the chapters enable the reader quickly to fasten on his particular point of the general subject and that, if one be still further interested, the index spreads before him the divergences.

Except perhaps as to a very few still disputed points the subject matter of the book is an expression of sound and well established accounting opinion, with the further potent merit of being presented in an interesting way.

The difficulties of arrangement alone in a work designed for this purpose are not to be lightly solved. In the first place there is the wide difference in the view which regards a business as a going concern and that taken in anticipation of its closing and liquidation. To keep this distinction clearly and persistently evident throughout a volume is no easy matter. Second, there is the important question of how best to present the subject in order that the idea may be readily grasped. Some minds more easily absorb an idea when presented in an abstract way; some in a concrete way; and for some the two, precept and ex-

Book Reviews

ample, are best commingled. The author has chosen, and I think wisely, the intermingled illustration and comment arrangement.

To sum up, Mr. Stockwell has here given us a book which is full of meat and well worth study and I went through it with a growing feeling that the credit man, banker or investor to whom it is addressed might justly complain of being enticed to absorb more information than was at the moment strictly necessary to his purpose. Such idea, however, will be far from the mind of the accountancy student or thoughtful practitioner, for such will read this book with interest and profit from beginning to end.

LOUIS G. PELOUBET.

ACCOUNTING, by W. A. PATON. *The Macmillan Company*, New York.
894 pages.

It is a pleasure to receive a new work on accounting by Professor Paton, for there is perhaps no other accountant who equals him in keenness of insight, careful analysis and penetrative interpretation.

The new book is in reality a thorough-going revision of *Principles of Accounting*, of which Professor Stevenson was joint author. In a rough way it follows the same arrangement, though the subjects treated in the new book are handled at greater length. A saving is accomplished by omitting the disproportionately long treatment (covering over one hundred pages) of the interest problem, which was contained in the earlier book, and by also omitting the somewhat inadequate attempt to treat of special fields of accounting, cost accounting, municipal accounting, railroad accounting and auditing. And finally the new work is made almost incalculably more serviceable by the inclusion of some hundred pages of well selected and carefully arranged accounting problems.

Professor Paton places some emphasis on his chosen formula for bookkeeping, that is, assets = equities, as against that made familiar by Sprague, assets = liabilities + proprietorship. The change is not one to which any particular objection can be made. But it is possible that he, with pardonable prejudice, overestimates the significance of this innovation, for he states: "It must be borne in mind that two quite distinct elements are included under the head of equities, proprietorship and liabilities", (page 73). To some it would seem that there is little significant difference between saying that the right-hand side of the balance-sheet contains two distinct categories, liabilities and proprietorship, and saying that it contains only equities, but these are divided into "two quite distinct elements."

In so far as "equities" is adopted to prevent the continuance of the prevailing custom of heading the right-hand side of the balance-sheet simply "liabilities" the proposed substitution is admirable. Indeed Professor Paton states that the adoption of the new term was made "especially to avoid the confusion," for obviously all the items in the ordinary balance-sheet are not liabilities. It is wrong to label the right-hand side of the balance-sheet "liabilities," for it contains both liabilities and proprietorship items. But it is somewhat confusing to find, on page 37, both of these two distinct categories described in a model balance-sheet as "ownership." It is true the heading reads "equities" but the two items are "student, ownership," and "neighbor, ownership," the

former of these items representing the proprietor's capital, the latter a liability for borrowed goods. Perhaps there is in Professor Paton's mind a fine distinction between proprietorship and ownership, which so far seems to have been overlooked by Crabb and the makers of dictionaries. But it seems to many that, if it is objectionable to list both liabilities and proprietorship under the name of the former, it is quite as objectionable to describe these two distinct classes by a word which seems a synonym of the latter class.

Special interest is to be taken in Professor Paton's masterly discussion of appreciation. This has from the beginning been a feature in his accounting theory. Professor Paton was perhaps the pioneer in boldly coming out for consistent treatment of fluctuations in value as against the current, falsely-called conservative practice. Accountants have in practice drifted a little toward his view, doubtless influenced by sweeping price fluctuations coinciding with the adoption of income and excess-profits taxes. On the other hand, it seems that Professor Paton has become a little less pronounced in his views on the subject. In his first work there were many pages given to defending the doctrine that appreciation, even of fixed assets, should be shown. In his *Accounting Theory* stress is put on showing appreciation of current assets. In the present work, the author still advocates showing appreciation, (no real accountant ever changes his views) but it seems, at least to the present reviewer, that he advances the views with somewhat more reserve, with a little less positiveness.

There is only one point in the book which the present reviewer cares to criticize. This is the adoption of the term "net income" as the balance of earnings from which both interest and dividends are to be subtracted. Net income, as used by the interstate commerce commission, is a pretty well crystallized term. It seems unnecessarily confusing to use it now with an entirely different content. Professor Paton argues most soundly that the balance which he calls "net income" is of great significance and its amount should be brought clearly to the attention of those reading an income statement. Perhaps "gross income", the term used by the commission, is not entirely satisfactory to Professor Paton. But one who had the originality to devise the term "equities", would surely have been able to think up some new term rather than to use an old term with a new meaning.

HENRY RAND HATFIELD.

THE PROFESSION OF AN ACCOUNTANT, by ALBERT CREW. *Gee & Co., Ltd.*, London. 117 pages.

The preface of *The Profession of an Accountant* states that the book consists of articles which appeared originally in several English law or accounting journals. Four chapters deal with professionalism as a whole, with especial reference to the profession of an accountant. Two chapters are devoted to notes on the legal profession. The following table of contents and a few excerpts may serve to give the reader an idea of the scope and character of this excellent little book.

Contents: Some characteristics of a profession; professional etiquette; registration and recognition; the right to use professional designatory letters; recognition and registration of the legal and other professions; some aspects of

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the legal profession; stamping of receipts for professional fees; professional dinners; books on professionalism; notes—(a) expulsion from a professional institute or society, (b) professional advertising, (c) statutory registration.

EXCERPTS

“A profession has been defined as a trade which is organised for the performance of functions. It is not simply a collection of individuals who get a living for themselves by the same kind of work. Nor is it merely a group which is organised exclusively for the economic protection of its members, though that is nominally amongst its purposes. It is a body of men who carry on their work in accordance with the rules designed to enforce certain standards both for the better protection of its members and for the better service of the public. Its essence is that it assumes certain responsibilities for the competence of its members, or the quality of its wares, and that it deliberately prohibits certain kinds of conduct on the ground that, though they may be profitable to the individual, they are calculated to bring into disrepute the organisation to which he belongs.”

“No one can fail to be impressed with the beneficial effect on a brain-working profession of its effective organisation, in the way of raising the standard of professional honor, improving the education of its members, increasing the opportunities for their professional training, disseminating improvements in professional technique, and even in promoting the scientific study of its subject-matter. In all these ways professional organisation has for its result an improvement of the service which the profession has to render to the community; and it is not a matter of complaint if, coincidentally, there is also a raising of the status of the profession in public consideration and even an increase in its aggregate emoluments and privileges.”

“The professional accountant has been described as an independent expert, undertaking, in return for a professional fee, to execute work for, or to give advice to, a succession of clients, subject to a duty to the public which makes him morally, and in some cases legally, responsible for the accuracy of anything to which he puts his name; and for the impartial exercise of any office of trust. The profession may be said to have come into existence as a sequel to the great outburst of joint-stock enterprise of the middle of the nineteenth century, and the growing intricacy of accounts in large enterprises, partnerships and trusts.

“The Institute of Chartered Accountants and the Society of Incorporated Accountants and Auditors have not only made accountancy a profession, but have given it dignity and status, and compelled the world of commerce and industry to recognise its worth and value, so that the terms ‘chartered accountant’ and ‘incorporated accountant’ are to-day almost as commonly understood and appreciated as those of ‘barrister’ and ‘solicitor.’”

“Accountancy is therefore a profession, not only because it is properly organised by the institute and society, but because it has the same characteristics of other professions. What then are the essential characteristics of a profession? A profession must be independent, controlled and governed alone by its own members, and relying entirely upon itself. It must not be bolstered up by mere window dressing like a limited company with its guinea-pig directors, or a mere society which requires for its support presidents, vice-presidents and other ornamental persons who are distinguished in every way except in those things which the profession aims to be or to do. A profession is not a mere society of men and women but an independent body of persons, skilled and learned in some calling or vocation, which skill and learning are recognised at large.”

“No one, however eminent, can become a lawyer, a medical man, or a chartered or incorporated accountant unless he enters such profession by

the straight and narrow paths of examination, professional training and experience, to which there are no by-paths or short cuts. Nothing adds so much to the strength, dignity and status of a profession as the strict adoption of this rule of admission."

"Objections may easily be made as to the unreliability and imperfections of the examination test, but all professions without exception require entrance by examination, not because it is the best test, but because it is the only fair and practical test."

"The difference between trade and profession is clear. The essence of the former is that its only criterion is the financial return which it offers to the individuals concerned. The essence of the latter is that though men enter it for the sake of a livelihood, the measure of their success is the service which they perform, not the gains which they amass. They may, as in the case of the successful doctor, grow rich, but the meaning of their profession both for themselves and for the public is not that they make money but that they make health, or safety, or knowledge, or good government, or good law. They depend on it for their income, but they do not consider that any conduct which increases their income is on that account good."

"It will be sufficient to say that in a profession its governing body not only considers the rights of members but exercises discipline and control not only as between individual members of the profession but also between members and the public who employ them; that there are no restrictions as to the number of members who may enter the profession; and that there is always the highest endeavour to increase the standard of knowledge, experience and ability."

"Professional etiquette may be described as the unwritten code of honor by which members of a profession are prohibited from doing certain things deemed likely to injure the interests of their brethren or to lower the dignity of their profession."

"Many professions, including that of accountants, are governed and controlled, *inter alia*, by disciplinary bodies, and in their charter or by-laws such professions specify certain acts or conduct which may lead to expulsion or suspension."

"The characteristic feature of professional self-government is the development within its organisation of rules of conduct which are enforced on its members; the development of professional ethics is perhaps one of the best results of professional organisation. These rules relate either to the conduct of professional men to each other or to their conduct towards the community in general. The rules relating to the conduct of members, *inter se*, generally forbid competition and advertisement, discourage the adoption of unorthodox views, and prevent the association with unqualified persons of their own profession, and even qualified persons of allied professions. These rules tend to good feeling and the maintenance of a high standard of honor between members of the profession. The rules relating to the conduct towards the community in general seek to distinguish between what is permitted to a professional from that which is permitted to a business man. There is an insistence on a profession being regarded as a vocation founded upon specialised educational training, the purpose of which is to supply disinterested counsel and service to others for a direct and definite compensation, wholly apart from expectation of other business gain.

"Business men may compete with one another in price and quality and use the arts of advertising in selling their goods. They may enter into secret understandings with others with regard to the sharing of profits and will endeavour to prevent anyone else from making use or profit of any new invention or discovery. Professional men, on the other hand, are always assumed to gain their livelihood by the sole use of their faculties—

except in regard to a limited class of assistants—they are prohibited from having any interest in the things which they recommend to their clients. Any receipt of commissions from other professionals, or from business enterprises, is against professional etiquette. In his private relations with individual clients the professional man is prohibited from using the influence that he gains as a professional man to extract from his client anything more than his recognised remuneration. Any attempt to use his professional position as an opportunity for injuring his client is condemned as infamous conduct. So long as he is professionally engaged, the member of a brain-working profession is required to think only of the advantage of his client, and not of his own interests. In the higher ranges of professional ethics he is expected to risk, and even to sacrifice, his health or his life in the performance of his professional duty, an expectation which never exists in business."

"Usually, unprofessional conduct of a member consists of acts or omissions which are likely to injure the interests of other members, or to lower the dignity of the profession and usually comprises one of the following:

"(a) Advertising.

"(b) Holding offices or engaging in other business which are not incidental to or consistent with the profession.

"(c) Touting for work.

"(d) The giving of commissions or presents for the introduction of business.

"(e) Accepting fees less than the recognised minimum fees."

"State jurisdiction, which usually results in bureaucratic control, rather tends to equality between members at the expense of efficiency and initiative.

"Obviously, a profession which adopts registration must necessarily lose some of its independence, and it is a matter in which there may very well be great difference of opinion as to whether registration is so very attractive and desirable as it appears to be. It is usually the policy of the state, when it grants a monopoly, e.g. to allow none but registered members to practise, to accompany it with some control."

"The highest ideal of a profession is public service, which, indeed, is its main function; the distinguishing characteristic of a profession is its independence as evidenced by its complete self-government."

The book is an English book. It is written by an English barrister-at-law for the English (or, at most, the British) reader. Necessarily, it discusses the subject from the English point of view, English both temperamentally and historically, from the standpoint of English law, from the viewpoint of approved English practice and procedure and in the light of English customs and precedents.

There are many differences between English practice and law and American practice and law. It is, perhaps, natural that the writer of this review should generally prefer the American way and consider it an improvement over the English way. But there is one difference between the profession of an accountant in England and the profession of an accountant in the United States in which his preference for things American is not so enthusiastically patriotic. In England the accountant himself has generally adopted a professional point of view and his professional status is rather generally recognized and conceded by the business and lay public. In the United States the laity is only beginning to recognize his professional claims while many practitioners, although claiming professional status, as yet have an unprofessional point of view and pursue many unprofessional practices. Indeed some practitioners disclaim

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the professional status altogether—some with such financial success as to engender a great lust after the fleshpots and seriously to hamper the efforts of the organized profession to find itself.

This little volume contains much that will be found interesting to the American professional accountant, as well as the American layman, if he be a person who already has what might be described as the "professional sense" or if he be a person who has the capacity for seeing from the professional viewpoint as distinguished from the commercial, or merely vocational, viewpoint. I would especially commend the book to those hopeful souls who pin their faith to legislative restrictions with their inevitable bureaucratic interference and control, in preference to the slow, but certain and enduring, development and growth of professional standards and ideals which are evolved from within the body of the profession itself and are enforced by the power of example and the sanctions of an informed and enlightened public opinion. In view of the present hysteria which sees a cure for every real or fancied ill of the social or economic body by simply enacting a statute, perhaps a reading of this little book will at least raise a suspicion in the mind of the reader that not everything which glitters must necessarily always be fine gold. This little book will also be very helpful to those upon whom devolves the duty of leadership during these formative years in the development of the profession in this country.

CARL H. NAU.

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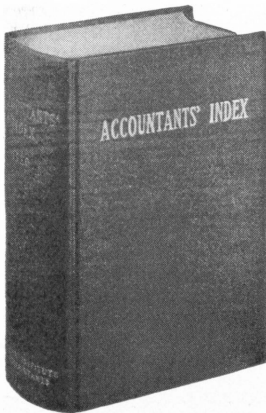
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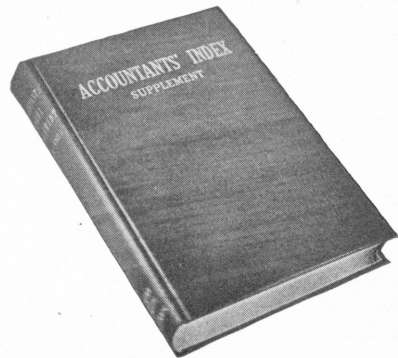
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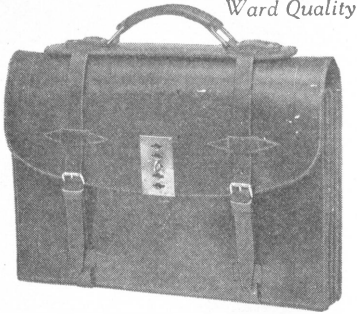
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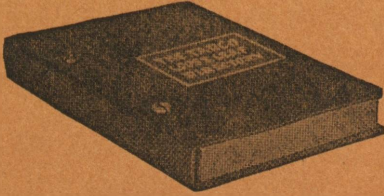
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