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Judgment guiding financial statements

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plays the rôle of partner in the enterprise. There is little wonder that he should feel a keen desire for as much data as possible reflecting the condition, progress, and outlook of the business concern.

The progressive and wise business man who has or seeks credit relations with bankers looks the matter squarely in the face. His philosophy teaches him that full and frank statements promote confidence. He approaches the banker with the feeling that he has nothing to lose and everything to gain by supplying all that the banker or the bank credit man desires and requests. He is usually rewarded by all the consideration to which he is entitled.

The public accountant occupies a position which is unique and exacting. Possessed, after an examination of his client's books, of information such as the banker desires, and, from his technical familiarity with the banker's needs, able to supply the data in the form desired, he is at the same time in a confidential relation with his client and under obligation not to disclose the information except by consent.

The broad-minded, far-seeing business man realizes the advantage to himself of putting the accountant in a position where he may satisfy the banker. Such procedure makes for better credit relations; for less trouble and annoyance to all concerned. It cannot help but facilitate the checking and granting of credit.

The tendency of borrowers who are progressive is to give every one who has occasion to think about the credit risk an opportunity to review all the facts relating to the business concerned. The ranks of business men who see the situation thus are growing rapidly. The signs of the times point sharply away from the primitive.

Judgment Guiding Financial Statements

THE executive of today is an individual of complex functions. He plans, directs, investigates, checks up, confers, and weighs opinions and information. He correlates the factors which comprise his organization; transforming and applying the motive power which they generate according to the requirements of the business. Alone, he is limited in his observation and output, and insignificant in his ability to accomplish. Aided by his organization, and with comprehensive information, his potential ability becomes enormously enlarged in scope and intensity.

The modern executive is essentially a desk worker. He is a presser of buttons and a user of automatic devices for purposes of communication. But thereby he conserves his time and energy. In this lies one of the secrets of his enlarged capacity; his opportunity for concentration and application.

Fancy the president of a large corporation having to visit his power plant in order to find out what kind, quality, and quantity of coal is being used in the generation of power. Consider what would happen if the sales manager were obliged to count up his stock before accepting a large order for immediate delivery. Think how business would be retarded if the treasurer of a company should have to call up the bank to determine the amount of his balance before drawing each check. Yet these are some of the absurdities which would be stern realities if modern business methods had not provided the individual with artificial means of overcoming the limitations of time, distance, and technical complexity.

Devices for providing the executive with information are many and varied. Forms galore have been drawn for the embodiment of data which will assist him. Reports,

daily, weekly, monthly, and yearly, keep him advised of the status and progress. Details and summary give him as much or as little as he may desire to know. The information flows to the point where the authority is concentrated in order that proper action may be taken on the basis of facts.

The man who guides the affairs of a foundry company has before him the stock and purchases of pig iron, scrap iron, coke, coal, limestone, and foundry supplies; the daily production and daily shipments. This is not only much more dignified than prowling around in the foundry and perhaps having the furnaces dumped while there, but much more efficient, since it places all the strings in one hand to be pulled or not as circumstances warrant. Market conditions may suggest purchases. Financial conditions may or may not warrant such action. Production may need to be stimulated or curtailed; shipments speeded up, or sales solicited. With the centralization of information proper correlation becomes possible. The executive who is informed is in a position to act judiciously.

Accounting has been much referred to of late as an aid to administrative judgment and control; as a means of overcoming the limitations which surround the individual. The boss carpenter who had all his men in one shop or all with him on the same job where he could see them constantly had comparatively little need for accounting. The size, complexity, and methods of business enterprises today make good accounting imperative.

The Bulletin of the Amos Tuck School of Administration and Finance very succinctly describes the function of accounting as follows:

"Adequate accounting records and reports, intelligently utilized, serve to reflect conditions, measure results, analyze causes, and thus to furnish an indispensable basis for testing and formulating administrative policies. In the determination of investment values and in the analysis of credit risks, investors and creditors are guided by the facts revealed by accounting statements. Governmental control of public utilities, the levy of taxes on incomes and profits, profit-sharing and other plans for promoting industrial goodwill and co-operative efforts to standardize accounting methods in many lines of business, are forces which emphasize the value of scientific accounting."

To put the matter differently and shorn of all technicalities, it may be said that the purpose of accounting is to produce statements which will show how a business stands financially and what causes have been responsible for the financial progression or retrogression over a given period of time. This broadly summarizes the general purposes of accounting. The statements themselves are divided into two great classes, namely, balance sheets, or those which show condition at a given time, and statements of operations, or those which show either in summary or detail the financial forces leading up to and culminating in the condition set forth in the balance sheet.

A considerable amount has been written from a technical point of view on the subject of financial statements. Little has been written as to their interpretation and use in guiding administration. An attempt will be made in the discussion following to bring out this phase of the subject.

Some of the phases of financial condition which serve as subjects for analysis consist in those relations which exist between borrowed capital and owned capital; current assets and current liabilities; total capital, both borrowed and owned, as between fixed assets and movable, or liquid, assets; and the order and rapidity with which current assets, other than cash, may be converted into cash.

Taking up first the question of capital, it is highly desirable that any balance sheet

shall bring out clearly the dividing line between borrowed and owned capital; and that the tendency of relationship between the two divisions of capital should be carefully watched by those who are responsible for the financing of a given enterprise.

The bank credit man, always concerned with unfavorable tendencies in this relation, wherein the borrowed capital shows a tendency to get out of proportion to the owned capital, has evolved, among other ratios, one which is called "debt to net worth." This ratio provides for dividing the total debt, both current and funded, by the total net worth, net worth being the excess of assets over total debt, regardless of whether such excess is represented by capital stock or surplus.

The idea of expressing these relations in the form of a ratio is an excellent one; but unfortunately, the basis used is fundamentally unsound. The interpretation of results growing out of the use of this ratio may have a psychological advantage from the point of view of the credit man; but the results and significance, if carefully studied, will be seen to be misleading.

A preferable method of bringing out the relation existing between borrowed and owned capital would consist in setting up two ratios; one showing relation of borrowed capital to total capital, the other showing relation of owned capital to total capital.

For purposes of illustration, let it be assumed that in a given enterprise there is a total capital of $50,000, $10,000 of which is borrowed, $40,000 of which is owned. The borrowed capital will then constitute 20 per cent. of the total capital; the owned capital, 80 per cent. If, at some future time, the situation has changed so that, of the total capital of $50,000, $30,000 is borrowed and $20,000 owned, the borrowed capital will then constitute 60 per cent. of the total capital, and the owned capital, 40 per cent. The borrowed capital has increased three times, or from 20 per cent. to 60 per cent.

Using the method prescribed by the bank credit men, the same figures will show an incorrect result. In the first situation, where the borrowed capital was $10,000 and the owned capital $40,000, the ratio of debt to net worth would show that the borrowed capital constituted 25 per cent. of the owned capital, found by dividing $40,000 into $10,000.

In the second instance, where the relations have changed so that the borrowed capital is $30,000 and the owned capital $20,000, dividing $20,000 into $30,000 shows the borrowed capital to be 150 per cent. of the owned capital; and comparison of the borrowed capital in terms of percentage shows that it has increased six times, or from 25 per cent. to 150 per cent.

It is conceivable that there may have been some psychological madness in the method of the bank ratio, since the span in percentage is larger and tends to magnify the increase in borrowed capital. It is much easier, presumably, to scare a prospective borrower by pointing out to him that his borrowed capital has increased from 25 per cent. to 150 per cent. than by showing him an increase from 20 per cent. to 60 per cent.

The relation of borrowed capital to owned capital is an important matter to those who are charged with the financial responsibility for business enterprises. It is obviously something which must be watched constantly in order that the relation may not get out of proper proportion; but it is exceedingly important that the true relation should be shown and understood. The idea of ratios is a splendid one, but they should be so planned as to reflect correct relations and tell the true story.

(*To be continued*)

date of the balance sheet, but the possibility that there may be such at a subsequent date.

Comments are generally used by public accountants in reports on audits and examinations in order to explain certain items shown in the accompanying statements, to set forth detail which may be too voluminous to incorporate in the statements, to describe the procedure followed in the verification of assets or the confirmation of liabilities, to qualify certain work done or explain why other work was not done, etc. Comments are also frequently included in the annual printed reports issued by the larger corporations for some of the reasons already mentioned.

This seems to be an appropriate time to bring to your attention the fact that the calendar year is not always the natural business year, and that there may be some date other than December 31 which is the logical time to take the inventory and close the books. For generations it has been the custom of a large part of the business world to take the annual inventory at December 31 without, in a great many cases, any good reason for so doing except custom. The proper time for taking the inventory and for closing the books is at the end of the natural business year, which means at a time when stocks of merchandise are at their lowest and when the liquid condition of the business is most favorable.

In the case of the inventory, it means a saving of time, money and energy to take it when the stocks are small, and when, possibly, employes are less employed and can co-operate more effectively than they could if there were heavy demands for production. When the liquid condition of the business is most favorable, that is undoubtedly the time to present yearly financial statements to banks and credit agencies, as it is then that the amounts of cash and accounts receivable are large and those of inventories and accounts payable are small. This question is of sufficient importance to merit the consideration of all business executives in order that they may determine if they are using their natural business year for inventory taking and for closing their books of accounts, and there is none more interested in bringing this question to the attention of the executives than the professional accountant.

Judgment Guiding Financial Statements

(Continued)

THE significance of the term "financial strength" depends on the point of view. The person who looks at a balance sheet from the ranks of money lenders considers the amount of capital and surplus which must be lost before his claim is endangered. The stockholder has only the surplus between him and his investment. There is every chance then that as he looks at the balance sheet of a corporation in which he is financially interested his eye will first seek the amount of the surplus.

The word surplus is subject to various interpretations. Legally, or as usually interpreted by the courts, surplus is the excess of assets over liabilities and capital. As generally understood, it means that which has been earned as a result of operations; the accumulation of profit or margin of selling price over cost.

Surplus may also be derived from a revaluation of assets; from assets acquired without any corresponding liabilities; from a decrease in liabilities without a corresponding decrease in assets; or from the acquisition of net assets taken up at a

figure in excess of the value of capital stock issued in exchange therefor.

Accounting procedure which seeks properly to draw distinctions in order that precise reasoning may result therefrom, differentiates this surplus from that which has resulted from operations, and earmarks it with some such title as capital surplus. This appears not to restrict such surplus legally from use for dividend purposes, but gives notice that the amount involved was not acquired in the usual way.

There is a tendency in balance sheets setting forth the financial condition of corporations having capital stock without par value to ignore not only any distinctions with regard to surplus, but even that between capital and surplus. This presumably is on the theory that the excess of assets over liabilities belongs to the shareholders. If this is so, why bother with fine distinctions?

There are various reasons, it seems, why it is desirable to show more than the net difference between assets and liabilities on the balance sheet as "shareholders' equity." In the first place, a balance sheet should present as many facts and phases incident to financial condition as possible without unnecessary detail. It should so present the information that it will be intelligible to anyone who may read it, irrespective of his kind or degree of interest. Shareholder, bondholder, merchandise creditor, or director, should find on the balance sheet data sufficient for his reasonable satisfaction or consideration for purposes of action. Above everything else it should be a frank, honest statement with nothing concealed.

A balance sheet showing the excess of assets over liabilities as shareholders' equity does not meet these requirements. It conceals, whether intentionally or unintentionally, the distinction between capital and surplus. There is no way of telling whether or not deficits from operation have encroached on paid-in capital; or if surplus, where it exists, has been earned or created as the result of a revaluation process.

The idea is erroneous that no accounts are needed for capital and surplus in corporations having capital stock without par value. It is equally wrong to pursue the theory that no such differentiation should be made in the balance sheet. Nothing could be more important than to bring out in the balance sheet the contributed capital, the surplus resulting from revaluation, etc., or capital surplus, and the surplus from operations. While such procedure might startle the conservatives unduly, considerable light would be thrown on the situation if the net increases and net decreases in surplus during the five-year period just preceding the date of the balance sheet were to be shown by years thereon.

Information of an interesting and instructive nature regarding the variations or changes in capital is brought out by a balance sheet which shows the figures at successive dates with comparison. A statement of this kind through the increases and decreases in amounts will show the fluctuations in capital, both borrowed and owned, and how such fluctuations have applied to the assets. Thus the fact may be brought out that additions to property or equipment are being financed out of current borrowings; or, on the contrary, that profits instead of being paid out as dividends are being put back into the property.

Not long since, a comparative balance sheet brought out the fact that a certain organization, while incurring an operating deficit of $195,000, increased the current accounts payable $197,000 and put $280,000 contributed for general purposes into property.

A comparative balance sheet is also use-

ful in showing the utilization of proceeds derived from bond issues or other obligations for special purposes. It does not take the place of an income statement, but on the other hand it supplies information as to capital fluctuations which the income statement does not show.

(*To be continued*)

Auditing Liabilities

FOR some years text books on auditing emphasized the procedure incident to beginning an audit. That there was such a thing as ending an audit seemed to have been entirely overlooked.

In similar manner the tendency seems always to stress the verification of assets. Volumes have been written on the subject. Instructions galore have detailed the procedure. But the important matter of auditing liabilities has received relatively little attention. We, therefore, reproduce certain suggestions which have been used and found helpful in covering the principal items under this head.

All liabilities may be divided into three main classifications, and those subdivided further as follows:

1. DIRECT OR SPECIFIC:
   - (a) Notes payable discounted at banks
   - (b) Notes payable sold through brokers
   - (c) Notes payable to individuals for loans
   - (d) Notes payable and acceptances to trade creditors

   All of the above may be again classified as:
   - Notes secured by collateral
   - Notes unsecured
   - (e) Accounts payable—trade creditors
   - (f) Accounts payable—miscellaneous
   - (g) Consignments (in)
   - (h) Unclaimed wages
   - (i) Unclaimed dividends
   - (j) Deposits or prepayments on account
   - (k) Judgments
   - (l) Contracts
   - (m) Mortgages
   - (n) Bonds
2. CONTINGENT:
   - (a) Notes receivable discounted
   - (b) Acceptances
   - (c) Endorsements (accommodation notes)
   - (d) Guarantees
   - (e) Unfulfilled contracts
   - (f) The minute book
3. ACCRUING:
   - (a) Pay roll
   - (b) Taxes
   - (c) Interest
   - (d) Rent
   - (e) Gas, electricity, water, heat, etc.
   - (f) Freight
   - (g) Commissions
   - (h) Traveling expenses
   - (i) Legal expenses (litigation in process)
   - (j) Damages
   - (k) Dues and miscellaneous accruals
   - (l) Audit fees
   - (m) Liability insurance

DIRECT OR SPECIFIC:

(a) Notes payable discounted at banks: There is greater possibility of deliberate deception being practised in connection with notes payable than in almost any other liability, and the greatest vigilance is necessary to be sure all are accounted for. Those payable at banks if at the regular banks of deposit are readily verified by certificate; the danger lies in the possible use of other banks and the use of the resulting funds without entry on the books.

(b) Notes payable sold through brokers: The verification of these transactions is usually difficult owing to the inability to trace the paper further than to the brokers. However, the minutes should be examined

placement at the same value as the property originally destroyed; to wit, "the new or restored property to the extent of the replacement shall not be valued in the accounts of the taxpayer at an amount in excess of the cost of the old property (or of its value as at March 1, 1913, if acquired before that date, and such value is higher than cost) after making a proper provision in either case for depreciation of the original property."

Compliance with this provision results in crediting such excess to a reserve, instead of to surplus, either free or restricted; and, when the cost of replacement exceeds the original cost of the property, charging the excess against the reserve. Thus, recovery on a piece of property the book value of which might be $250,000, being insured at replacement values at $400,000, when destroyed by fire and compensated by insurance in the amount of $400,000, would have the effect of increasing the assets of the company in question in the amount of $150,000. The bookkeeping entries would consist in charging cash with $400,000, crediting property with $250,000, and reserve for replacement of property, or some other appropriate title, with $150,000. As payments are made on the replacement contract, property would be charged until the cost had reached $250000, after which charges would go against the reserve.

Assuming now that the reserve has been obliterated, the property worth $400,000 is carried at $250,000. There is no avoiding the fact that a secret reserve has been created, and secret reserves are contrary to good accounting; yet there appears to be nothing else to do in the face of the Treasury Department regulations—having in mind always that such procedure is necessary only for tax purposes.

Judgment Guiding Financial Statements

(Continued)

ONE of the most important phases of financial condition with which the balance sheet treats is current or liquid condition. This is represented by the current assets and current liabilities. The significance is brought out by a comparison of these two groups of figures.

The position of these groups of items on the balance sheet is, after all, a matter of little importance. There is strong contention on the part of some accountants that the liquid condition is the thing of prime importance to the greatest number of interested parties, and hence the current assets and current liabilities should be stated first on their respective sides of the balance sheet. Whether or not the first contention is so, is largely a matter of opinion. If true, the liquid status may be determined as easily under one arrangement as another, so long as the groups are made to stand out and may be readily compared.

The matter of importance is the items which go to make up the respective groups, and the dependence which may be placed upon such items. If the groups are taken in total and compared one with another, a ratio known as the current ratio may be developed. Whether or not this ratio is satisfactory will depend upon many things. What would be a satisfactory current ratio in one case might be far from satisfactory in another. There should be a natural variation as among wholesalers, retailers, and manufacturers. Ratios should be affected by the peculiarities of industries, geographical and economic variations, and

other causes, some, perhaps, as yet undiscovered. Research and investigation to bring out these various points is under way by a well-known association of credit men. It is probable that the near future will see more or less accurate bases established with which satisfactory comparisons may be made.

The tendency in the past has been to state the current relation in terms of simple numbers, showing the number of times which the current liabilities are contained in the current assets. The effect of this is, of course, to show the number of dollars of current assets to each dollar of current liabilities.

Another way, perhaps a better one, and incidentally one toward which the bank credit men seem now to be inclined, is to show the ratio of net liquid assets to the total liquid assets—or in other words that percentage of the total liquid assets which is free and clear.

Still another way, and one which accomplishes the same purpose, would be to show the ratio of current liabilities to current assets.

The effect of these two latter methods is merely to show the two equities in the liquid assets; one, the equity of creditors, the other, the equity of proprietors.

The important thing is to establish some uniform method or uniform terminology, so that everyone will use the same method and language in stating the current position.

There is little value attaching to a current ratio until it has first been determined that the items included in the current assets and current liabilities respectively are proper ones. Unfortunately there is considerable difference of opinion, particularly between bank credit men and accountants, as to what may properly be included under these heads. The banker is undoubtedly justified in his conservatism; but there is perhaps some danger that the bank credit man will become too mechanical in his work if he attempts to follow blindly ratios and barometrics which automatically exclude certain items. The proper use of current or any other ratios contemplates that such use will be tempered with the facts surrounding the particular case, and good judgment dictated by common sense.

Two of the items which accountants are likely to include in the liquid assets, and which credit men are likely to cast aside, are listed corporation bonds and stocks at market, including United States liberty bonds and war savings certificates at market, and amounts due from controlled or related concerns under current liquidation.

The banker of course takes the position that a prospective borrower with funds invested in securities has no standing, since instead of attempting to borrow from banks, he should convert his securities into cash. This is an entirely plausible reason why the banker may refuse a loan, but scant reason, apparently, why securities which are readily marketable and may at any time be converted into cash, should be excluded from current assets.

The situation would be quite different with regard to liquid condition were the securities held for ownership, control, or advantage through affiliation, for the purpose of return on investment, or otherwise restricted as to conversion. In any of these events the item would have no place among the liquid assets but should be set out separately on the balance sheet.

On the other point, the banker contends that he has no desire to finance related, hidden, or underlying companies, which he might readily be tricked into doing were he to loan to a concern having extensive intercompany financial relations. This objection is entirely reasonable, and the banker frequently insists on a consolidated statement, in order that he may see clearly the interrelations.

But again, where inter-company accounts are under current liquidation, that is, the accounts and notes receivable from related companies are being collected as rapidly as those from outsiders, there appears to be no logical reason why such accounts should not be included under current assets. It is of course desirable that such items as have been discussed should be clearly identified in the balance sheet, so that the amounts involved and relations may be apparent; and while from a practical banking point of view there may be some good purpose in considering them when granting or withholding credit, certainly from a point of view of good accounting there can be no such excuse for excluding them from the current assets.

(*To be continued*)

Auditing Liabilities

(Continued)

(g) Consignments (In):

Goods may be received on consignment and part or all sold without the liability therefor being spread on the books. If it is found that any goods are handled on consignment all records of such should be called for and carefully reviewed to establish the liability therefor.

(h) Unclaimed wages:

Unclaimed wages are frequently redeposited without proper liability being shown. In every audit the method of treating such items should be the subject of inquiry and if not properly handled steps should be taken to have the liability set up.

(i) Unclaimed dividends:

The next preceding remarks apply to this item.

(j) Deposits or prepayments on account:

These are usually easy of verification through the letter file or otherwise. In cases where interest on the deposit is involved as in public service companies, or where the company does a pseudo-banking business, receiving monies from its employes, both principal and interest should be carefully checked.

Prepayments on accounts are usually very temporary in nature, but they should be scrutinized to make sure that they should not have been transferred to the accounts receivable ledger.

(k) Judgments:

Disputed accounts sometimes give rise to litigation and judgments adverse to the client may have been secured. The particulars of all such items must be obtained and steps taken to have the liability therefor set up.

(l) Contracts:

Every contract the terms of which are specific such as land contracts, etc., forms a direct liability. The agreements should be seen and noted and the liability as shown by the books should be adjusted to the terms of the contracts.

(m) Mortgages:

(n) Bonds:

These liabilities should be verified by certificate and the documents should be read to ascertain if all the contractual requirements have been complied with.

Contingent:

(a) Notes receivable discounted:

These should be listed and verified by certificate from the banks where discounted. This is not sufficient, however; the status of all notes under discounts should be investigated and if it is probable that any will not be paid when due, a

client, or other prospective readers of the report, and search out the facts concerning such points so that he may intelligently and truthfully convey such facts. More constructive reports would be rendered if accountants were to prepare and have before them from the early stages of the field work the balance sheet and income statement, according to the books; if more time were spent in consideration and reflection and less in pointless action.

A report narrative made up of live, interesting information about the organization; its condition, progress, tendencies, outlook, and relations, should be stimulating. A lot of technical explanation must be monotonous and depressing, if indeed it attracts enough attention to be read in full. The meaning of results is much more important than an exposition of the manner in which they were derived. Interpretation requires thought. The inexperienced accountant need not attempt it. At the hands of competent parties facts gleaned from figures may be made the basis for sound, logical, and profitable business administration.

Judgment Guiding Financial Statements

(Continued)

CREDIT men probably are responsible for the current relation of "two for one" so-called; meaning that safety as to current position requires at least two dollars of current assets for every dollar of current liabilities. The responsibility for establishing this standard is difficult to fix; but the ratio was evidently initiated by some one either in authority or in the confidence of credit men generally, since it was accepted and used widely until of late without much question. It is said to have grown out of the need, constantly being impressed on those concerned with credit, for a goodly margin of safety, rather than the result of any analytical study. That it was conservative, in that it afforded a margin of one hundred per cent., is perhaps responsible for its adoption.

The current ratio with all that it signifies is obviously a most useful expedient, particularly for "snap-shot" purposes. It expresses a relation which shows the condition of working capital at a glance. The importance of following working capital from date to date cannot be over-emphasized. Yet before any comparison may be made with the current ratios of other organizations, thought must be given. It would be entirely misleading to compare the current ratio of a concern dealing in goods subject to change in style with one handling staple commodities. Conservatism in the case of style goods would dictate a much wider margin of liquid assets, particularly if among the liquid assets there were included a liberal amount of merchandise inventory likely to shrink in value when put to the test of realization.

Anything which is not reducible to cash within a reasonably short time distorts the current ratio. It is therefore easy to understand the urge which the bank credit man feels when he eliminates anything which may affect it, such as securities not readily marketable, any advances to related companies, and any charges to officers and employes.

Again, before anyone may draw conclusions from a current ratio it is necessary to know not only the line but the seasonal activities of the business; and even then conclusions are not safe without giving consideration to the relations, direct and cross,

of the items comprising the groups of current assets and current liabilities. A balance sheet showing a current ratio of one and a half to one may represent a condition entirely satisfactory in certain lines at any time, or it may be satisfactory in some lines at certain seasons of the year. The same current ratio in other lines or at different seasons might be alarming.

Thus a concern with a one and a half to one ratio may appear at the beginning of a busy season with notes and acceptances payable of $1,000,000, and open accounts payable of $500,000, and not give any particular cause for alarm as long as there is merchandise, $1,350,000, accounts receivable, $950,000, and cash, $60,000. But the same condition at the end of a season would ordinarily be a different matter. Even at the beginning of a season in this case there should be some cause for concern if the receivables were to average much over sixty days.

This company would not stand what the bank credit man calls the "acid test" and which consists in comparing the aggregate of the cash, accounts and notes receivable, exclusive of any which are past due, with the total of the current liabilities. It is doubtful if many concerns can stand this test, although occasionally a published balance sheet appears in which there are no current liabilities. The acid test is probably never applied as an absolute standard, but it is easy to see how, used as part of a series of tests, it is valuable particularly in watching tendencies. Companies which show improvement from time to time in this respect are rather apt to show a healthy condition or tendency theretoward. On the other hand, a movement in the opposite direction is frequently a sign that matters financial need watching, if something more radical is not indicated.

Because of the fact that the current ratio alone is not conclusive, other ratios have been evolved and used by bank credit men as a supplement thereto. These embrace not only relations among items on the balance sheet but certain items of condition linked up with factors of operation. Thus there are the ratios of sales to merchandise inventory and of sales to receivables, the significance of which in each instance is easy to grasp. But that there is any relation between the stock of goods carried for the purpose of supplying customers and the promptness with which customers pay for goods already purchased is difficult for the average person, even one who is familiar with accounting, to see.

Sponsors for the ratio of receivables to merchandise claim for it that it has a practical value when taken in connection with the current ratio because it may bring out, or rather draw attention to, certain unfavorable conditions which a favorable current ratio might obscure. It is perfectly apparent that an increase in the receivables without any increase in the current liabilities will improve the current ratio. At the same time such increase in receivables and corresponding improvement in current ratio may be at the expense of an increasing amount of slow or of bad accounts. This condition would seem to be more quickly discovered and accurately reflected by determining the age of the receivables than by comparing the receivables with merchandise. But in the absence of data as to sales and with only the balance sheet items of receivables and merchandise from which to work, the ratio developed therefrom may have some value once a standard or normal ratio with which to make comparison has been established. There appears to be no fundamental relation between receivables and merchandise as there is between merchandise and sales and between sales and receivables. It therefore seems essential to the logical use of the receivables to merchandise ratio that there shall first have been determined some

representative ratio based on experience. This normal or standard ratio may be that of one organization taken for certain seasons, periods, or stretches of years, groups of typical organizations in certain lines, or business organizations in general. The first two classes are likely to be the more satisfactory for comparison. When used for comparative purposes the receivables to merchandise ratio probably has certain usefulness in indicating tendencies and drawing attention to weakness in the item of receivables which requires attention.

(To be continued)

Auditing Liabilities

(Concluded)

ACCRUING: (continued)

(f) Freight:

For one reason or another, freight bills are sometimes held up, returned for correction, etc. All items of this character should be included when discovered.

Goods are frequently shipped f.o.b. destination. When that is the case there is a liability for freight to point of delivery which should be ascertained and provision made therefor. Clients should be questioned as to basis of sales in order to secure this data. This class of freight charges should be treated as a deduction from sales, and if taken up by the customer, treated as a reduction of the accounts receivable.

(g) Commissions:

Provision should be made for inclusion of all accrued commissions. Frequently they are only payable upon settlement by the customer and are only spread upon the books at intervals. Inquiry should be made in order that all accruing commissions may be taken care of.

(h) Traveling expenses:

Salesmen generally are fairly prompt in getting in their expense accounts, but officers of companies and those whose trips are infrequent, quite often neglect to report them, particularly if, as usually happens, the funds have been advanced to cover. Expense accounts should be requested and included in all cases.

(i) Legal expenses (litigation in process):

Attorneys are as a class very slow in rendering accounts for services. Inquiry should be made if any litigation is in progress and if so, request that the company lawyer be asked for his bill or an approximation of it so as to include this item.

(j) Damages:

While liability insurance is carried by most companies for protection, that does not cover their liability for damages in all cases, as the insurance companies seldom assume unlimited liability. Claims in excess of the amounts covered by insurance should be taken cognizance of in an audit.

Other damages may consist of claims for breach of contract, failure or delay in delivery of goods, claims by employes for damages on account of dismissal, etc.

While not found everywhere, damage claims are sufficiently frequent to warrant a little quiet investigation to develop the facts.

When found, they might be either accrued or contingent and should be treated accordingly.

(k) Dues and miscellaneous accruals:

Club and other dues and miscellaneous items of accruals need not be enlarged on.

(l) Audit fees:

Inasmuch as audit fees are always applicable to a prior period, it is well to

is but another way of distributing profits. And the argument has some force, except that it would be rather hazardous to the price of the stock were all shareholders to sell the shares received as a stock dividend. On profits distributed one way the government collects a tax; distributed the other way the government gets nothing unless some of the shares involved are sold.

With the grief generated by this last thought in mind certain persons, whether for reasons political or otherwise, have sought to invoke section 220 of the Revenue Act of 1921 as a means of penalizing the companies recently so affluent as to declare large stock dividends. The section in question is aimed particularly at holding companies formed or availed of for the purpose of preventing the imposition of a surtax through the accumulation of profits instead of a division or distribution thereof, and provides as a penalty an additional tax of 25 per cent. Other parts of the section leave such grave doubts about the administration of the law as to bring its practicability into question. For example: "The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case, unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business."

What Congress will in the future do with the tax law is perhaps an open question. That some legislator, or faction of influence, will urge strongly some measure taxing undistributed profits is almost a foregone conclusion. Some corporations are taking no chances.

Judgment Guiding Financial Statements
(Continued)

IN the movement towards statistical data as a basis for judgment, the possibilities of the economic or measurement accounts have been very little explored. At least there is little evidence to this effect. The reason for this in the credit field is a very practical one, namely, that customers infrequently submit detailed operating statements which show their business progress. One reason given by bank credit men for using the ratio of sales to merchandise is that they find difficulty in obtaining operating data beyond the sales. But because of the profit element involved in sales this ratio is not as informative as it might be.

Obviously, more accurate and basicly sound information would come from a comparison of merchandise inventories with cost of the goods sold, or what is commonly known as turnover. But the fact remains that in the present state of enlightenment, in so far as the typical borrower is concerned it is not practicable to attempt research work depending on this data. Much discussion, and, in fact, controversy have centered around the question of how, properly, turnover should be computed. So granting it were possible to obtain the figures it would still be necessary to decide on the method before proceeding.

The formula generally accepted prescribes that the initial inventory applicable to any period shall be divided into the figure which results from adding the purchases during the period to the initial inventory and subtracting the inventory

at the end of the period. Thus, an initial inventory of $5,000 with purchases of $20,000 and an inventory at the end of $10,000 would show the cost of goods sold to be $15,000 and a turnover of three times. This method, stripped of all complications, gives a result which is clear and conclusive, whereas, dividing the merchandise into the sales, assuming that they amounted to $35,000, would show a turnover of seven times.

Like so many matters of statistics, it would perhaps make little difference which method is used, so long as either one or the other is followed consistently. However, the first method is fundamentally sound and logical without requiring anything for comparison, whereas the second is of value only when compared with the figure of some other period or with some standard figure. The turnover based on cost takes no account of the profit. It contemplates that the increment may be, figuratively speaking, pried loose and taken out, and therefore should not be involved in the computation at the risk of obscuring the true situation. The turnover based on sales is theoretically unsound, because of a compounding of the profit which gives in a single computation an inflated result. The true significance of sales is better shown in a comparison of the sales with the receivables. The proper significance of merchandise activity is better brought out through the relation of merchandise stock at cost to the merchandise sold at cost.

"But," says he who is wont to pick flaws in the most logical reasoning, "suppose there is no initial inventory?" Obviously, here is a situation to which the formula is not applicable. A concern having no stock with which to begin is not comprehended in the turnover class. The turnover computation is not applicable unless it is assumed that purchases during the first period of operation constitute the accumulation of stock. In that event the stock may not even, under the most favorable circumstances, be turned more than once. Under the formula described any merchandise remaining unsold at the end of the period becomes the initial inventory of the next period. Such procedure, it must be admitted, will at times produce some weird results. All of which leads to the conclusion that what must be used for turnover purposes on a cost basis is a fair average of stock carried. Using such figure and dividing it into the cost of goods sold during a given period produces turnover figures which are far more satisfactory and dependable than those resulting from any other method.

The significance of turnover figures is found principally in relation to progress or lack thereof. The figures constitute a measurement index. They indicate whether goods are being moved with satisfactory speed, or whether undue retardation is creeping in.

The merchant of two decades ago bought his goods in large quantities. He stocked up in anticipation of his needs for a considerable time in the future and got it over with, so to say. Quantity discounts loomed large in his survey of business efficiency. He was content to obtain a given return on his investment.

The modern merchant knows that if goods turned once will yield 4 per cent., goods turned twice will yield 8 per cent. Small profits with quick turnover is the thing to be desired. "Penny a pound profit," the slogan of a well-known candy concern, would be absurd if it were not possible to sell the product in enormous quantities and with a rapid turnover of capital.

Thus, an increasing turnover is a sign of business health. It is an indication of good management. Some of the best-laid plans for business organization have been frustrated by poor management.

Some of the staunchest business houses have been wrecked thereby. Turnover, therefore, is a valuable instrument for measuring or estimating the value of efficient management.

(*To be continued*)

Making It Easier

WHAT in the past has been one of the perplexing problems which public accountants have had to meet in Louisiana has been solved by the new constitution of that State, which became effective January 1, 1922. Under the previous law, business concerns were taxed on values at December 31 of each year, based on stock in trade plus accounts receivable minus accounts and notes payable. Cash was exempt. It was therefore desirable, from a point of view of state taxes, to have as little value as possible in accounts receivable and a maximum of cash. In order to accomplish this, business concerns frequently resorted to the practice, during the last days of December, either of borrowing from banks, in order to increase cash and notes payable, thereby creating an offset to stock in trade and accounts receivable, or selling outright their accounts receivable. With the coming of the new year such notes payable were liquidated, or such accounts receivable were purchased from the parties to whom they had been sold, thus restoring the original position of the concern with respect to the cash and accounts receivable.

This situation has always been a thorn in the side of public accountants. It is obviously almost incredible that accountants examining the records for the early part of the month following the period under examination should fail to observe the reversing entries. There was no disputing the purpose of the transactions prior to the close of the year. On the other hand, the transactions were in every way legal, and they resulted in a financial status at the end of the year which might not be denied.

The problem confronting the accountant was whether to accept what at December 31 was a fact, although subsequent information gave it the color of fiction, or to be governed by the intent and ignore, as it were, the false motions of post-Christmas manoeuvres. It was, therefore, a source of considerable joy to public accountants that the situation was corrected by the new constitution, Section 4 of Article 10 thereof reading thus:

> "The following property, and no other, shall be exempt from taxation: All public property, places of religious worship; * * * places of burial; * * * cash on hand or on deposit; * * * debts due for merchandise or other articles of commerce, or for services; * * *"

By including accounts receivable among the items now exempt from taxation, the incentive for manipulation has been removed. Whatever the effect upon state tax receipts may be, the new law should in this respect be very acceptable to public accountants.

Colonel Arthur H. Carter has recently obtained the C. P. A. certificate of the States of New York and Missouri, respectively.

Mr. W. L. Chaffee, manager of the Atlanta office, was elected a member of the City Air Board of Atlanta, subject to appointment by the Mayor, and duly appointed to the Board on October 10, 1922.

Mr. Page Lawrence served as toastmaster at the banquet incident to the regional meeting of the American Institute of Accountants at St. Louis, November 10, 1922.

PRESS OF WILLIAM GREEN, NEW YORK

Judgment Guiding Financial Statements
(Continued)

ACCOUNTING as a basis for policy-making is, frankly speaking, probably the ambition of every accountant who takes his profession or vocation seriously and sees its greatest possibilities. That accounting results are more and more being so used was recently acknowledged, very graciously, by a prominent engineer whose work brings him in contact with a large number of business establishments. If the statement is correct, and there is every reason to believe it, more attention should be given to interpreting the financial statements which accounting produces.

The mere compilation of financial figures is a useless and wasteful operation. The past has been too full of work which had as its objective the completion of statements by a given date after the close of a period, with great stress laid on accuracy. The importance of studying the figures, analyzing and interpreting them, and acting on the conclusions, has been largely overlooked.

The work of interpreting financial figures is a serious matter. It requires skill, intensive thought, and extreme care, as well as broad knowledge. There are many variables which may obscure the facts and affect conclusions. Bad reasoning is worse, frequently, than snap judgment. Wrong conclusions may result in wrong policies. Wrong positive policies are apt to be more dangerous than indefinite ones. Correct policy-making is possible only when the facts have been established.

A certain institution, under a new administration, recently showed very unsatisfactory results from a financial point of view. The deficit from operations had been increasing from month to month. The governing body at length determined on an investigation into the causes of the alarming financial condition.

A comparative study developed the fact that expenses in every category had increased over a corresponding prior period. The general price level having been lower, if anything, in the latter period, increased prices for the same quality of services and supplies could be eliminated as a factor in the explanation. But the fact was brought out that employes had been added to the pay-roll and the quantity of supplies per capita purchased and consumed had been increased. Increases throughout were traced to quantity and not to price.

Here appeared to be grounds for indictment of the new administration, but to have stopped at this point would have been unfair. Pursuing the investigation further, it developed that the general quality of everything about the institution had been improved. The care was better, the food was superior in quality and there was more of it, the tone of the whole place had been raised, and there was greater satisfaction on the part of everyone to whom the institution ministered. But the income during the period in question had not increased.

The problem then for the governing body was one of policy. Good service anywhere is relatively higher. If one wants good things he must pay for them accordingly. The questions to be decided in this case were whether to continue the present management and accept the standard of operation to which the institution had been scaled, while finding means of increasing the income to meet the expense incident thereto; to undertake the task of increasing the efficiency of operation, working through the present management; or to make a change in the management with the hope of obtaining someone more economical and equally efficient, but with the chance of reverting to the old order of

things, which had been far from satisfactory. The decision finally reached was to continue the present incumbent in management, counseling him in the matter of economy, and attempting to increase the income.

But what if there had been no adequate accounting system with the expenses comprehensively classified and the numbers for statistical computations not available? Guess work is a poor basis for administration. Policy-making, with all the facts from which to proceed, is sufficiently perplexing. Financial results and statistics, properly interpreted, are a substantial aid.

(*To be continued.*)

Book Review

Koehler, Theodore. *The Accounting Mentor* and *The Accounting Quiz-Answerer*, constituting volumes I and XII, respectively, of an encyclopedia. (New York, The Tri-service Accounting Corporation, 1922. Vol. I, 421 p., Vol. XII, 323 p.)

One is almost tempted to liken the first volume of these works to "The Print of My Remembrance," by Augustus Thomas, so sort of reminiscent is the style in which it is written. It is a fine book to read in a chair beside the fire when the quest is for entertainment as well as knowledge. The philosophy which runs through the pages gives it a human touch so seldom present in technical exposition. Similes there are in abundance; illustrations without number. The book is exceedingly well written in clear, understandable English. Furthermore, it contains a lot of practical information relating to accounting, both general and special. Some of the outstanding chapters are as follows: Accounting statistics, balance sheet and revenue good-will, municipal budgets, on-cost and accounts, genus and species of accounts, overhead charges.

Volume twelve, the quiz-answerer, in which Theodora Koehler collaborates, deals substantially with the four traditional examination subjects: theory, practice, auditing, and commercial law, utilizing for the discussion questions taken from C. P. A. examinations. The method is somewhat novel and unique in that the discussion of each section of questions is preceded by a so-called "The-mo-dex" which epitomizes the theory of each question and argument. There is some sound advice toward the end of the volume as to the use of spare time, particularly the evening hours. A well arranged index by subjects adds to the facility in using the book for reference purposes.

We have pleasure in announcing that Mr. F. M. McDonnell, formerly assistant manager of the Los Angeles office, has been appointed manager of that office, effective December 1, 1922.

At a regional meeting of the American Institute of Accountants held in Cincinnati on November 11, 1922, Mr. E. C. Gause led a discussion on "Determination and Treatment of Inter-Company Profits," and Mr. J. R. Wildman read a paper entitled, "Consideration of the Sinking Fund Method as a Basis for Amortizing Franchises."

Mr. G. R. Lamb acted as chairman of the local committee, which presented an unusually interesting program.

We are pleased to note from the *Railway Age* of October 28, 1922, the appointment of Mr. T. A. Hamilton, at one time manager of our Saint Louis office, as President of the International & Great Northern Railway.

PRESS OF WILLIAM GREEN, NEW YORK

Judgment Guiding Financial Statements
(Continued)

A QUESTION raised recently, while it relates primarily to non-par stock, has an important bearing on financial statements. Books are kept as a matter of recording details which are too numerous and too important to be retained in the memory. The function of financial statements is to set forth in summary form the financial condition in all its phases with a historical sketch of the most recent changes in such condition. Surplus as a phase of financial condition calls for consideration and statement as to its composition and origin, in order that dividend policies may be not only legally sound, but economically and financially rational.

The question follows:

"A corporation had outstanding 7,500 shares of stock having a par value of $10 each and had accumulated a surplus of $1,500,000. In January, 1921, it changed its capitalization from 7,500 shares of $10 each to 15,000 shares of no par value, but made no entry on its books. Because of the present agitation for a tax on surplus, the management wishes to make the books reflect the change in the capitalization by transferring the amount of $1,500,000 from surplus to capital on the theory that that portion of the present surplus was capitalized at the time the new stock was issued. Would such procedure be proper?"

Attempting first to answer the question, it is doubtful if there has been any change in the capitalization. The changes which have taken place are the form of stock and number of shares representing ownership. There is neither more nor less capital than before, nor has the amount of surplus changed. The change in the form and number of shares does not automatically convert the surplus into capital. Action by the directors specifically transferring the surplus to capital is necessary before such combination may be regarded as having taken place. Capitalization is usually interpreted to mean the amount which appears in the capital account. Hence, before it would be proper to make the books reflect a capitalization of $1,575,000 it would be necessary to have the directors authorize the transfer of $1,500,000 from surplus to capital.

Such procedure might be entirely proper but apparently ill-advised. To so dispose of surplus might result in embarrassment if future operations fail to provide profits out of which dividends may be paid, and put the corporation in the illegal position of paying dividends out of capital. When all the surplus is transferred to capital the door to future dividends is closed until sufficient additional profits have been made to provide for such dividends. The experience of many concerns in the latter half of the year nineteen-twenty should be sufficiently practical to deter any corporation from taking this unnecessary step.

It is evident that in order to solve many of the present-day problems of non-par stock the consideration of a few sensible fundamentals is necessary. Capital is a portion of wealth invested in an enterprise with a view to gain. Surplus is an accumulation of net gains derived primarily from operations. It may also spring from increases, due to economic conditions, in values of possessions. Dividends are declarable only out of surplus. This is not only in accordance with sound economics, but controlled in most states by law.

The proprietary equity represented by capital stock without par value is the excess of assets over liabilities. But this equity needs some classification. It would be about as logical to issue an income statement showing one item for expenses with-

out classification as to set up a balance sheet with the proprietary equity shown as a lump sum. Part of it is capital on which dividends may not encroach. Part of it is perhaps surplus resulting from operations and available for dividends. Some of the equity may be surplus arising from revaluation of assets and while available for dividends legally is not in the form of liquid assets which may be distributed in satisfaction of a dividend declared.

Where is the sane director who wishes to base his dividend action on a financial statement which may get him into trouble with the law? It is only common accounting sense that a balance sheet, whether the stock be with or without par value, should show the capital, the surplus arising from operations, and the surplus arising from revaluations. Only with such information before them will directors be able to form judgments and dictate financial policies which are at once logical and safe.

(*To be continued*)

Overcoming Tradition With Thought

TRADITIONS are difficult to overcome. The fact that a thing has been done in a certain way for years seems, in some circles, to give it a vested right which is indestructible. The English firm of accountants who, when a former apprentice sent them an American form of income statement for perusal as a matter of interest, replied that they had been making their statements in a certain way for thirty-five years and thought they wouldn't change, offers an illustration which is typical. Another English firm, when receiving an American balance sheet in the same manner said: "Yes; it's a very good statement, but fancy putting the liabilities on the wrong side."

So there are many things about accountancy practice, regardless of the geographical location, which go on year after year in the same way, because of tradition.

A certain report of a certain client had appeared in the same way for several years. The statements were anything but creditable from an accounting point of view, but no one would take the responsibility for changing them, because it was contended that they met the wishes of the client. The client was consulted. He expressed ignorance of the history back of the form of statement in question, and admitted the supposition that the accountants were responsible for the absurdity. Knowing little about the technicalities of accounting, he had not felt qualified to criticize. He was sure of one thing, however, that he had never understood the statements.

Accordingly, the sham of tradition was broken down. The debris was cleared away, and the foundation laid for a new structure based on reliable information.

Sudden changes are not desirable. They are apt to cause shock. And a client suffering from shock is not always an easy problem. But there is generally a way to handle such matters so as to prepare the mind in advance without causing shock.

In the case just cited, it was suggested to the client that a year hence the report should be changed. He was advised to discuss the matter with his associates so that they would be prepared for the change. Having laid this foundation, it was an easy matter a year after the original incident to prepare a statement both clear and comprehensive, and one which the client subsequently confessed he was able to understand for the first time in the course of his relations with the accountants.

Auditing practice is more or less a slave

Judgment Guiding Financial Statements
(Continued)

THE purpose of an interest expense account is to show the cost of borrowed money. Hence the item for interest expense appearing in the income statement should show the true relation of the amount reflected by such item to the outstanding indebtedness representing borrowed money. This theory, if firmly adhered to, will settle any question as to the proper set-up on both balance sheet and income statement in cases where outstanding bonds are bought up or called by the company which issued them. It should be possible in any financial statements prepared so as to reflect conditions clearly, to refer to the income statement and see what was the cost to the company of the borrowed money during the period under consideration.

It is for this reason that bonds purchased or called are best shown on the balance sheet as a deduction from the liability with the net figure extended, whether or not the bonds have been cancelled. The advantages derived from such presentation are that not only is the net liability outstanding shown, but there is also reflected the policy of the company in reducing the liability voluntarily before it is legally called upon to do so, and the extent of such reduction. The interest is best shown net in order that it may bear the proper relation to the outstanding liability

There is frequently a technical accounting question which arises where bonds are purchased or called as to whether it is proper to deduct such bonds from those representing the liability if the bonds purchased have not been redeemed. Financial officers sometimes contend that such bonds are treasury bonds, just as stock once issued and subsequently acquired is treasury stock. Such position results in a fiction which the practical facts soon break down. When the time comes to pay interest no interest is paid or charged on the purchased bonds, even though they have been kept alive.

This discussion does not relate to bonds which are purchased for sinking fund purposes, either by the sinking fund trustee or by the company, and turned over to him, and where interest on such bonds is paid regularly to the sinking fund trustee until the bonds mature. In such cases there is no question as to whether or not interest shall be set up broad, since the interest credit applicable to the purchased bonds goes to reduce the interest expense unless perchance the interest earned is absorbed by a sinking fund reserve.

The idea of carrying purchased bonds as an asset is based on the theory that they are investments. Not only does the theory break down when the interest is considered, but is complicated by the fact that the bonds may have been purchased or called at a premium. Because they are company securities this feature is sometimes overlooked. Were they not treated like the securities of any other company and the premium amortized over the balance of the life, the company would find itself in the position of having to charge off the premium, perhaps in a considerable sum, against the year in which the bonds mature.

Interest expense is affected not only by the straight interest paid on bonds outstanding, but by the premium on bonds purchased, together with a proportion of any discount, if any, on the whole issue of bonds when sold and the unamortized portion of discount applicable to the bonds purchased. Any interest expense figure

which shows less than this fails to show the true situation. Without this data it is impossible to form any intelligent opinion as to the company's financial judgment in the matter of rates on borrowed money.

(*To be continued*)

Book Review

The Correspondence Course in Accountancy Offered by The Syracuse Extension Institute of Accountancy, Inc. Volumes 1 and 2. (Syracuse, New York, 1922.)

This course comprises some fifty lessons, beginning with the most elementary consideration of bookkeeping and proceeding to such advanced studies as cost accounting, auditing and the technique of financial and statistical reports. The text, which is contained in three volumes (the last of which is still in preparation) has been written by John A. Powelson, A. B., C. P. A.

Throughout the text and the auxiliary material there is evidence of the most thoughtful and painstaking effort to make the course thoroughly practical. The course is logically arranged and is well calculated to give the student an excellent general knowledge of accountancy. The text is well written and is to be commended for its lucidity. A fairly thorough review reveals no cause for criticism of the accounting principles and practices taught.

A very interesting and valuable feature of the course is a series of ten booklets on "How to Study at Home," written by Professor Mark May, psychologist. These cover such topics as Planning the Campaign, Study Habits, Concentration, Learning and Memorizing, and Mental Fatigue. It is well recognized by those who are familiar with correspondence courses generally that a large number, perhaps the majority, of those who undertake the work fall by the wayside, largely through the lack of mental stimulus. These booklets, which are supplemented in a practical way by the introductions to lessons 1 to 18 (Volume 1) showing how to study each lesson, should have a salutary effect in sustaining the interest of the student and in helping him to study in such a manner as to make the course really beneficial.

To summarize, one is impressed with the practicality of the course, as regards both subject matter and presentation.

The Town Hall Bulletin of January 15, 1923, devotes some space to sayings of former prominent men whose lives and works are commemorated by the dedication of chairs in the Town Hall. Included among the list of those whose birthdays fall in January is the following:

"Charles Waldo Haskins, January 11, 1852. 'Accounting as a progressive science, must be the same yesterday, today, tomorrow, except that as a development it is older and wiser as time goes on.' "

At a luncheon for Dodge Brothers Dealers held at the Pennsylvania Hotel, New York, Tuesday, January 9, 1923, which some of our members from the Executive Offices were privileged to attend, one of the features of the entertainment following the luncheon was a car-assembling contest. Two teams of eight men each, composed of veteran employes of Dodge Brothers, were chosen for this performance because of long and faithful service as well as skill. The two teams were designated and costumed: one as the blue team; the other as the white team. From the various parts comprising a Dodge Brothers car each team, at a given signal, began the work of assembly. The blue team put the car together, started the en-

Investigation shows that many accountants make more working papers than are necessary. Rare judgment is required to determine what is appropriate under the circumstances of a given engagement. The things which need to be covered are those which are not easy to follow. Whatever is or should be apparent to the person of average accounting intelligence needs no special explanation. The data which should be set forth is that which will answer the meanest and sharpest question which anyone, friend or foe, might ask. Many papers are appropriate but not clear, while others are both appropriate and clear as far as they go, but do not follow the matter to a conclusion.

Clear trails are indicative of good work and clear thinking. They are helpful to the fellow who has to follow, whether it be an accountant on a repeat engagement or a principal who has to discuss matters with clients long after the man who did the work has forgotten about it. After all, the firm has to take up its place in the background, ready always to discuss, explain, or render service to clients, whenever or wherever required, and irrespective of when, where, why, how, or by whom, the work was done. Clear trails make such responsibility easier to undertake.

Judgment Guiding Financial Statements
(Continued)

OPINIONS may differ as to the effect which laws providing for preferred capital stock without par value may have on the affairs of corporations and individuals who are stockholders therein. There are always persons who view any attempt to point out possible pitfalls as destructive criticism. And opinion to the effect that laws permitting the issue of no-par value preferred stock are inviting involvement may be quite properly challenged. But the signs set up by many actual cases point so sharply to the conclusion that one who so opines need have little fear of being discredited.

A recent case shows a corporation having three classes of stock; cumulative preferred, convertible preferred, and common, all shares having a par value of $100 each. The balance sheet at a given date reflected a fair margin of surplus.

The company was reorganized by the formation of a new corporation having four classes of shares, all without par value, namely, cumulative preferred class A, cumulative preferred class B, convertible preferred, and common. The new stock was exchanged with holders of the old stock, share for share, except that for each two shares of old cumulative preferred a holder received one share of cumulative preferred class A, and one share of cumulative preferred class B. Incident to the transfer of values from the old to the new corporation certain assets were written down to the extent of several millions.

When the balance sheet of the new corporation was set up the work of ass'gning proprietary interests in the excess of assets over liabilities developed a peculiar condition. The provisions of issue gave values in liquidation to the shares as fo lows: Class A, $100 per share plus any accumulated or accrued and unpaid dividends; class B, $127.50 per share, less any part of $27.50 per share which might have been declared as additional dividends, plus any accumulated or accrued and unpaid regular dividends of the new corporation; convertible preferred, $100 per share; common, any remaining assets.

Attempting to take out the proprietary

equities in the order of preference and on the basis of liquidation values, it was soon discovered that not only was there nothing left for the common stockholders, but that the holders of convertible preferred shares would suffer a substantial reduction from the value per share to which they were entitled in liquidation.

It may be said, of course, that this position and assumption is based on a condition existing at the beginning of business on the part of the new corporation, and that future earnings would probably cure the condition and make good at least the equity of the convertible preferred shares. But the fact remains that were the shares all to have a par value, few corporations would care to present a ba ance sheet showing an impairment of two classes of capital stock.

There appeared to be nothing to do under the circumstances surrounding a corporation having an excess of assets over liabilities with various classes of preferred and common stock but to show the excess as representing so and so many shares of preferred stock at the various liquidating preference values and so many shares of common stock. For example:

Excess of assets over liabilities. . $3,000,000.00
Representing:
10,000 shares, cumulative preferred stock class A, without par value, entitled in liquidation to $100 per share plus accumulated or accrued and unpaid dividends.
10,000 shares, cumulative preferred stock class B, without par value, entitled in liquidation to $127.50 per share, etc.
20,000 shares convertible preferred stock, without par value, entitled in liquidation to $100 per share.
50,000 shares, common stock, without par value.

This obviously is something of a novelty in balance sheets and it leaves stockholders to figure out for themselves, so to speak, just what the respective classes of shares are worth.

Later developments produced further complications. At the first balance sheet date after incorporation of the new company there was a surplus arising from operations of, say, $100,000; one dividend had been paid on the class A stock; the first dividend on the class B stock had been passed. This situation was met on the balance sheet by adding the surplus from operations as a separate item below the display of capitalization; revising the previous caption to read, "Excess of assets over liabilities January 1, 1922" (date of reorganization); and appending a footnote to the balance sheet showing that the dividend on the class B stock had not been declared at the regular date, and that a cumulative right had therefore accrued to the holders of such stock.

On the basis of this case the question may be asked, "Does or does not the law authorizing preferred stock without par value give promise of causing trouble in the future?"

(To be continued)

At a meeting of the Office Managers' Section of the Manufacturers Club of Minneapolis, on January 19, 1923, Mr. A. F. Wagner, associate manager of the Minneapolis office, gave a talk on general accounting systems suggested for an ideal manufacturing company.

Mr. F. S. Shy, formerly a member of the staff at 30 Broad Street, New York, and now attached to the Boston office, has our congratulations on his attainment of the C. P. A. certificate of the State of Massachusetts, in November, 1922.

PRESS OF WILLIAM GREEN, NEW YORK

values have been used for inventory purposes, that consideration be given to the aspect of general valuation and the question of relative importance, than to meticulously transcribing the client's records and balancing out the pennies.

Judgment Guiding Financial Statements

(Continued)

THE moot question of reserves bobs up ever and anon. Some day it is to be hoped rationalism will clear away the confusion which has prevailed for many years, and compose the differences which the subject provokes.

The first difference which must be recognized apparently is that reserves are at least of two kinds: those which represent restricted surplus and those which are bookkeeping expedients for measuring decreases in values without disturbing the asset accounts. The first class may be characterized as true reserves; the second, false reserves.

Comparison of the two classes shows them to be not only different in character, but opposite in their relation to financial condition. The true reserve represents value, although set aside and ear-marked so as to prevent its appropriation for dividend purposes. The other class denotes lack of value, and indicates the extent to which value is estimated to have disappeared.

The differentiation then should be taken into consideration in preparing a balance sheet, because of the significance bearing on financial condition. True reserves, being portions of surplus restricted as to use, may correctly, it seems, be shown on the same side and in the same group as the capital and surplus. Whereas, the reserves which measure declines in value should more appropriately be deducted from the assets to which they relate.

This rule, while apparently simple, is often attended with difficulty in its application, because the purity, so to speak, of the various reserves is not maintained. Reserves for depreciation are properly deducted from the property assets, but to conform to the rule the reserves should contain nothing other than depreciation. Special provision for anticipated, although uncertain obsolescence, theoretically has no place in a depreciation reserve and should, strictly speaking, be set apart by itself, and so designated. Practically, the controlling influence should be the proportions existing between the depreciation and special obsolescence elements. That is to say, if the preponderance of the reserve represents depreciation, although there is an element of obsolescence involved, practicality permits the reserve to be deducted. On the other hand, if the reserve is true and the depreciation element is the smaller, the reserve may be set up broad. This infraction of rules is made necessary by the mixing of the two elements. It might be avoided if two reserves instead of one had been set up, in which event the reserve for depreciation would be deducted, while the reserve for obsolescence would be set up broad.

Something of the same thing sometimes happens with regard to the reserve for doubtful accounts. The reserve sometimes will cover not only certain accounts which are doubtful of collection, but make provision for uncollectible accounts which may develop in the future. Again, strictly speaking, the reserve is a mixed one, and only that part which applies to accounts receivable already on the books should be deducted from the asset. But because of the practical difficulty of separating

the reserve, this is seldom feasible and it is usually safe, unless the element of provision for anticipated losses on future sales is excessive, to deduct the reserve.

Procedure in the matter of handling reserves should always be guided by common sense. One may wish ever so strongly that reserves might have been set up in sufficient number, and with sufficient care to permit of proper allocation on the balance sheet, but wishing is frequently beside the point. Even though the differentiation of reserves and the disposition of the respective classes in accordance therewith may be accepted, it is still sometimes difficult to treat them properly and consistently, because of the mixed elements which they contain. In such cases one should incline to the conservative, which leans towards deducting the reserves from the assets. Equal care must be observed, however, that the conservatism is not carried too far and violence done to the surplus.

(*To be continued.*)

A Way Out

A CERTAIN New York corporation having accumulated a deficit equal to about forty per cent. of the capital stock outstanding and feeling an urge to clean house, as it were, sought the means through a change in the form of capital stock from common stock having a par value to common stock without par value. The procedure adopted was to file an amended charter providing for a stated capital, with which the corporation would carry on business in the future, equal to the number of shares outstanding, at $5.00 per share, the minimum value permitted under the New York statutes when the stated capital is based on an amount per share.

Incident to the change in the form of shares certain physical assets were written down to their intrinsic value and reserves were provided for possible losses resulting from uncollectible accounts. These write-downs would, if no change had occurred in the capitalization of the corporation, have resulted in an impairment of the capital represented by the capital stock with par value to the extent of about seventy-five per cent. thereof, but after the change in capitalization, with minimum stated capital, a surplus appeared.

This case presents several interesting questions, such as the legality of the procedure, the income tax aspect, and the position of creditors in the event that dividends to the detriment of creditors should be declared out of surplus without further accretions thereto from earnings. The procedure appears to be entirely legal under the New York State law, which, through alternative provision, makes it possible, so long as the charter so specifies, for the corporation to carry on business with a stated capital equal to the number of shares outstanding times an amount per share not less than $5.00. The corporation, therefore, was apparently within its legal rights in reducing the capital, as was done.

The tax question is perhaps not so easily answered, but there is probably no chance that there would be income tax to pay, since such surplus as was set up really constituted capital designated as surplus, and instead of having a profit of any description the corporation in reality sustained a loss.

It is also doubtful if creditors could prevent the distribution of dividends out of surplus, but it seems somewhat likely, although it is a point which future cases will probably have to decide, that the corporation might be found in violation

Reading satisfies a hunger of the mind. The motives which lead a man to a book vary with each one's mental makeup. He who is wise will neglect none of them.

The most obvious and natural purpose in reading is for self-advancement. Our school years are our first initiation; and happy is the man whose taste, thus early formed, leads him to seek wider pastures. As we take up the work of life, we find the value of books increasing in direct proportion to the widening of our mental outlook and our worth to the community. This class of reading can never be laid aside; rather does it become more and more necessary as our interests and responsibilities increase.

We turn to books also for amusement and recreation—many times they may even be potent sedatives, bringing us a beneficent, if temporary, relief from the cares and trials of life; a forgetfulness which it is well to seek when the mind and body are weary or the nerves tense. At another time a happily chosen book may act upon us like a tonic, pulling us out of the dull rut in which we sometimes settle down, and giving us the invigorating lift of a new idea or a fresh resolve. Such a book is a real inspiration in the most practical sense of the word. Like oxygen to the lungs, its refreshment acts upon the dormant brain cells, energizing them into new life and activity.

Of all the influences exerted by books, beyond question the most important to a man's inner life is the development of his imagination and the deeper forces of his nature. He cannot afford to neglect this enriching experience.

So that books, those mere "sheets bound or stitched together," may bring unthought gifts. They are ours for the taking.

Judgment Guiding Financial Statements
(Continued)

IN the case of a certain New York corporation having only common capital stock without par value the certificate of incorporation provides that the stated capital shall be $500, plus such amounts as shall be received from sale of stock together with any amounts which the directors may transfer from surplus.

Certain of the shares were sold at $100 per share; others at $50. Shares to the extent of seventy-five per cent. were issued to the organizers, in exchange for the right under a contract to manufacture certain patented automobile parts. The corporation did not acquire the patents; merely the right to manufacture and sell under these patents. The corporation officials wish to value the contract, in order to take advantage of any benefit which might accrue under a restoration of the excess profits tax.

Now comes the question as to the proper basis and method of valuation. Except for this desire on the part of the corporation officials, probably the best way, everything considered, would be to carry the contract without value, except possibly a one-dollar value, and make no attempt to show any other money value in the capital account. This being impracticable, because of the ideas of the officials, one other way would be to have the directors, by resolution, place a value on the contract and take up the corresponding amount in the capital account. It might also be possible to value the contract at an amount derived from the number of shares issued for the contract taken at the lowest rate at which

any of the stock was sold for cash.

The most scientific method would probably be to take the average estimated net earnings for the first three or five years, preferably three years, and considering one-half of this amount to arise from the contract, capitalize that figure at six or eight per cent., preferably six. Halving the net earnings is of course arbitrary, but it is founded on the theory that there is no logical basis for apportionment of the net earnings as between the capital invested in plant, equipment, etc., and the contract. It might logically be contended that the equipment would be of no avail in connection with the manufacture of this particular article without the contract. On the other hand the contract is of no operating value without the equipment. Whether two-thirds of the net earnings may properly be imputed to the contract and one to the capital invested in equipment or *vice versa*, no one is in position to say, and it therefore seems logical to divide the earnings equally as between the contract and capital invested in equipment.

Regardless of the method employed, it seems desirable that the capitalization of the contract should be made as conservative in amount as possible, for the reason that later some other board may take the position that the contract is over-valued and move to reduce the value. Here would arise, probably, the serious question as to the right of directors to reduce the stated capital without due process of law.

(*To be continued*)

Eternal Vigilance

A CASE has recently been reported wherein irregularities on the part of a treasurer of a corporation located outside of New York City were detected by public accountants through using envelopes bearing their own return card instead of that of the client in sending out confirmations to banks.

The irregularities had occurred in part as follows: The treasurer maintained a fictitious bank account with a fictitious bank in New York City; for example, the Herald Square Bank. This account was a dormant one. Previous to the audit conducted by the accountants in question the audit work had been done for several years by another firm of accountants which had always used envelopes bearing the imprint of the client in sending out for confirmations. There being no such bank in existence as the Herald Square Bank, the post office department, obviously not being able to locate the bank, returned the letter to the client.

The treasurer, receiving the returned letter, opened it; completed the confirmation, signing a fictitious name as representing an official of the Herald Square Bank, inserted the confirmation in the envelope bearing the accountants' corner card and brought the envelope to New York City where it was mailed, reaching the accountants in due course of mail delivery. By this method the treasurer is said to have concealed a considerable shortage for a number of years.

While there is no reason to doubt the facts as reported in this case, it appears that accountants examining the accounts from year to year and finding the dormant account, probably increasing in amount from year to year, should have been on notice to make a more careful investigation than might usually be the case where an account of this kind is found.

A famous quotation might be paraphrased in its application to accountancy so as to read, "Eternal vigilance is the price

government department, such as the Department of Commerce, the present period of prosperity might, it would seem, be considerably extended.

Judgment Guiding Financial Statements
(Continued)

SOME of the complications predicted in connection with capital stock having no par value are already beginning to arise. One case which presents some of these complications has to do with a corporation, the charter of which provided for both preferred and common shares without par value. The preferred carries a cumulative provision with respect to dividends. In the event of liquidation or dissolution this stock has an expressed value of $100 per share.

There are three times as many common shares as preferred authorized and three of the five directors are elected by the common shareholders. This provision remains operative as long as the preferred dividends are paid; or at least in the event of default in the payment of three consecutive semi-annual dividends on the preferred shares, the holders of the preferred shares may elect for the unexpired term three directors to replace those representing the common stock. The whole board is subsequently elected by the preferred shareholders and continued until all arrears in dividends on the preferred stock have been paid up.

The corporation was organized for the purpose of acquiring the property of a certain bankrupt corporation and to offer an opportunity to the stockholders of that corporation to participate in a new attempt to carry on the business which had been unsuccessful. The practical purpose of the plan was to effect a reorganization, although it was brought about by the establishment of an entirely new company. For purposes of identification the two corporations may be referred to as the predecessor and successor corporations.

Under the terms of an agreement between the successor corporation and certain shareholders of the predecessor or bankrupt corporation the latter were offered the opportunity of exchanging their shares for those of the new corporation "dollar for dollar." This was the basis specified in the agreement, but as subsequent developments will show, was not strictly adhered to. The shareholders in the defunct corporation were, however, allowed to value their shares, for purposes of exchange, at cost. And it should be added that their shares were of the common class and without par value.

The new company stock was valued for exchange purposes at ninety dollars per share in the case of the preferred and seven-fifty per share in the case of the common. Further, it was stipulated that the privilege of exchange should only be extended to shareholders of the predecessor corporation who would pay in an assessment of $2.25 per share of old stock. These funds were put into the hands of a committee representing the new corporation, with instructions to purchase from such funds the plant property of the bankrupt corporation. And it was provided further that these funds should be regarded in fact as advances from the old stockholders and be returned to them out of the so-expressed first profits made by the new corporation.

It so happened that twenty dollars per share was the cost placed on the old stock for exchange purposes. Where exchanges could not be effected otherwise cash was collected by the new company to equalize.

These amounts of cash were, however, insignificant. For example, twenty shares of old stock exchanged for four shares of preferred and six shares of common of the new company required a collection of but five dollars in order to equalize the amounts.

Eight thousand shares of the common stock valued at twelve and one-half cents per share were issued to the organizers of the new company in consideration of services rendered. The last item in the recital of facts shows that the successor company charged all the stock of the predecessor company purchased to a goodwill account at cost.

Here, indeed, is an interesting case. Boiled down the only "real money" in the capital account is the small amount of cash collected on account of equalization in exchanges of stock. A balance sheet made at this point with the plant purchased but not paid for would show among the assets plant property at the purchase price; but the offset would be a payable in favor of the vendors. There would be some cash, but most of it was received through advances from old stockholders and must be returned to them out of the first profits. A payable in their favor would therefore appear among the liabilities. The value placed on the shares of the predecessor company acquired would rest in the goodwill account with the corresponding credit appearing in the capital account. Organization expense likewise would be shown as an asset; an equal amount being included in the capital account. All in all, there is very little tangible value representing the proprietary equity; the only asset of this character being the cash received on account of equalization.

When the substance has been extracted from the mass of form and legal technicalities it appears that the new corporation has acquired a plant to be paid for with money borrowed from stockholders under an agreement not to declare any dividends until this money has been paid back. It does not necessarily follow that the surplus from operations up to the amount of the indebtedness to stockholders for money borrowed will pass automatically to capital. But payment of the liability would leave the property asset standing as a free capital asset and while the surplus might be declared away as dividends the chances are that there would be no cash out of which to pay the dividend. It would therefore be but logical that the surplus freed by the liquidation of the liability should be passed to stated capital so as not to take any chances on declaring it away.

No particular damage seems to have been done by the involved manipulations with the non-par value stock. As long as the same individuals hold both preferrred and common stock, there is not likely to be any question. But if the common stock becomes separated from the preferred and the corporation should have to be liquidated there might very well be some objection from common stockholders to allowing preferred stockholders one hundred dollars per share particularly when under the most favorable construction they could not be considered to have contributed more than ninety dollars of capital per share.

The possibilities of capital stock without par value seem far from having been exhausted. In the case herewith all the manipulations were made possible without rendering any of the holders of the new stock liable for any deficiency in the par value. In other words all the stock, no matter what was done with it, became from the time of issue full-paid and nonassessable.

(*To be continued*)

We announce the appointment, effective May 1, 1923, of Messrs. Lewis A. Carman and H. Brooks Davies as managers of the Los Angeles office.

Judgment Guiding Financial Statements

(Concluded)

SO much has been written in opposition to preferred capital stock without par value that it is but fair to point out one thing in its favor. As might be expected, this class of stock has a somewhat natural appeal to investment bankers or investment houses marketing securities, particularly of public utilities, where the money market may call for a scaling up or down of the prices per share at which preferred stocks are sold. Where they have a par value it is obviously difficult to sell them at less than par without having to resort to some subterfuge, such as having the discount on all shares of subsidiary companies absorbed by a parent company. This results in some cases in a considerable burden to the parent company, particularly when there are a number of subsidiaries and there is a good deal of activity in issuing securities. The need for adjustment of prices arises especially where there is not much difference between preferred stock and junior bond issues and where, in order to dispose of the preferred stock, some concession must be made.

Bond investment houses bringing out issues of public utilities looked originally with much favor on preferred shares having no par value. Some of them admit that they did not foresee the complications which the stock led them into, such as having to fix the respective stock equities, in cases where both preferred and common shares were issued, in making settlements under reorganization and merger agreements. Since the early days, however, there has been some relief from embarrassment in this respect through the introduction of the redemption value idea.

The series of articles on judgment guiding financial statements is brought to a close with this number. One reason is the fact that the articles have become somewhat disconnected and specialized, and it is thought that their continuance in serial form under this subject heading might be misleading. A further reason is found in the recent appearance of a most noteworthy book which treats of analysis and interpretation of financial statements rather exhaustively. Doubtless there will be something to say, from time to time, on the subject of financial statements and capital stock without par value, in which event separate articles will appear under appropriate headings.

Mr. W. H. Bell has recently been appointed Chairman of the Admission Committee of the New York State Society of Certified Public Accountants. Mr. Bell has for some time served as a member of the Society's Board of Directors.

Mr. E. E. Leffler, manager of our Buffalo office, has accepted the post of acting head of the Department of Accounting at the University of Buffalo for the coming year.

At the annual meeting of the Oregon State Society of Certified Public Accountants held in Portland on June 11, 1923, Mr. R. J. Leo was elected a director for the ensuing year.

Our congratulations are extended to Messrs. C. J. Drake and E. T. Gregory, of the Detroit office, on their recent attainment of the C. P. A. certificate of the State of Michigan.

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