VOLUME XII.

JANUARY, 1929—DECEMBER, 1929

NEW YORK

HASKINS & SELLS

15 BROAD STREET
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Organized Thought

The idea that certified public accountants need to have an interest in accounting as the chief instrument which they employ in their work is not prompted by sentiment alone. A desire for economic survival and preëminence, whether secretly cherished or openly admitted, probably is the principal motive. Whatever the motive, the idea will avail little unless it is put to work.

Accounting theory and practice, like the accountancy profession, has evolved without much guidance, or organized planning. Too often those who have pondered the subject of accounting and formulated its theory have not been entirely familiar with the practical side. Those engaged in practice have had little time, or use, for theory. Sporadic efforts to correlate theory and practice have not been noteworthy in the results achieved.

There is a medium, however, through which combined force may be applied in putting into practice the idea of developing accounting. That medium is the professional society.

The assertion that every accountant in the professional field should be a certified public accountant scarcely can be challenged. If the greatest good is to be accomplished by organized effort, it does not seem too severe or arbitrary to suggest that every certified public accountant should be a member of a state society.

The state societies, through their technical committees and technical sessions, constitute a means whereby accountants may manifest their interest in accounting. Further, these societies offer an opportunity for research, for thought, for discussion, for education, and for concerted action in matters relating to accounting and accountancy.

Individual thought, even that of a genius, does little good unless it is communicated. Individual effort makes little progress unless it is combined with that of others. A good idea gains momentum only as it is seized and passed along by one group to others of larger proportions. Accounting principles, in order to stand up against practical contact with other forces whose representatives have different points of view and modes of thought, need the united support of the accountancy profession.

Perhaps no better words to express the situation can be found than those in which an analogy was stated recently by Mr. Charles W. Appleton, vice-president of the General Electric Company, before the 44th Annual Meeting of the Association of Edison Illuminating Company, in an address on “Our Mutual Interests in Research Engineering,” to wit:

“But nature so endowed man that he might be able to cope with and overcome the onslaught of all the other forces hidden in its bosom, and of all its gifts, the greatest was the God-given faculty of organization, association, and cooperation with his fellows.”
Appreciation From the Point of View of the Certified Public Accountant

By John R. Wildman

Address Delivered at a Meeting of the American Association of University Instructors in Accounting, Chicago, December 27, 1928

The certified public accountant’s interest in the subject of appreciation is a practical one. He is forced to consider the matter in connection with his review of accounting and his certification of financial statements.

The facts are, whether or not such procedure is justifiable, that physical property and intangible assets frequently are revalued by, or at the instance of, the owners of such possessions who attempt, in various ways, to give expression to the estimated increases in value. The certified public accountant, therefore, is confronted primarily with a condition; not a theory.

The authority for the restated value may be either a report of independent appraisers or a resolution of corporation directors.

Inasmuch as the certified public accountant does not attempt to act as an appraiser, to pass judgment on the work of such persons, or to assume responsibility for the values which they fix, he accepts their judgment and qualifies his statements accordingly.

Inasmuch as corporation directors, in some jurisdictions, are empowered by statutes to fix values, and even though not specifically so empowered are within their corporate rights in so doing, the accountant usually takes the position that he must accept their judgment when they revalue assets, provided there is no fraud involved and they officially record such acts in the corporate minutes. In such cases the accountant places the responsibility on the directors by proper explanation in his statements.

The occasions for revaluations which give rise to estimated increases in values are various. One corporation may wish to bring out a bond issue. Another corporation may wish to offer an issue of preferred stock. Still another company may see in the procedure an opportunity to overcome a deficit in capital, thus preparing the way for future declarations of dividends payable in cash. A fourth concern may wish to use the restated value as a basis for depreciation and thus increase the charge for depreciation against earnings.

In one particular case, a company owning city realty considered using an appraised valuation for the purpose of restating its land and building values, crediting the estimated increment in land values to surplus available for cash dividends. This was done on the theory of equalizing the increase in value among the stockholders over a period of years, rather than giving the benefit of large profits to the shareholders at some future time when, and if, the profit might be realized.

In another case, a company having on its balance sheet a large amount of deferred charges which had accumulated as the result of numerous refinancings, caused certain intangibles to be revalued, credited the amount of the increase to capital surplus, and wrote off the deferred charges against such surplus.

Cases, illustrating the use which is made of asset revaluation in order to take advantage of an estimated increase in the value of such assets, might be continued at length. It is doubtful, however, if a continuation would develop uses substantially different from those already described.

The principle is well settled, and is specifically exemplified in cases such as the one involving the directors of the American Malting Company (65 N. J. Equity 375), that anticipated profits may not be made the basis of dividends payable in cash. In that case, quoting from the opinion written by Judge Clarke, “These contracts were to deliver at a future time a product not yet
made from raw material, not yet purchased, with the aid of labor not yet expended. The price agreed to be paid at that future time had to cover all the possible contingencies of the market in the meanwhile, and might show a profit, and ran the chance of showing a loss. When the sales actually took place they were entered in the books. But to calculate months in advance on the results of future transactions, and, on such calculations to declare dividends, was to base such dividends on paper profits—hoped for profits, future profits—and not upon the surplus or net profits required by law. It does not seem to me that you can "divide," that is, make a dividend of a hope based on an expectation of a future delivery at a favorable price of what is not yet in existence, under the statute."

The principle is generally accepted, and is supported by Jennery v. Olmstead (36 Hun 536), that a rise in market prices over the cost of commodities carried as current assets does not justify a credit to profit and loss, or an increase in earned surplus. In the case of Jennery v. Olmstead, the court had to pass on the question of whether an increase in the market value of United States bonds, than which nothing could be more marketable, was a proper credit to profit and loss. The court held that it was not.

In further support of the principle that unrealized increment does not constitute a profit distributable in the form of cash dividends, might be cited Marks v. Monroe County Permanent Savings and Loan Association (52 N. Y. St. Rep. 451, 22 N. Y. Supp. 589) in which it was held that unearned discount was not so distributable.

The statutes of Ohio (General Corporation Law of 1927, Section 8623-38) require that "Cash dividends shall not be paid out of surplus due to or arising from (a) unrealized appreciation in value of or a revaluation of fixed assets ***

In the outstanding case of Eisner v. Macomber (252 U. S. 189) the United States Supreme Court held that in order to be subject to taxation, income must be shown to have been "derived" from capital, and not merely a "growth or increment of value in the investment." ***

"Enrichment through increase in value of capital investment is not income in any proper meaning of the term." This case, of course, will be remembered as the one in which stock dividends were declared by the Supreme Court to be non-taxable.

In another case which arose in connection with the Profits Tax Laws, the United States Supreme Court held in the case of La Belle Iron Works v. United States (256 U. S. 377) that appreciation could not be included in invested capital.

If contractual rights to receive in the future, amounts in excess of cost, or an opportunity to realize profit through resort to a ready market, do not warrant the recognition of increased asset value, it does not seem that any opinion expressed by, or in behalf of, the owner of property, can effectively increase the value of such property to the same owner.

The conclusion well may be reached, therefore, that an estimated increase in the value of assets, even if the estimated increase is recorded in the books of account of an enterprise, does not increase either actually, or constructively, the surplus available to that enterprise for distribution as cash dividends.

Exception to the foregoing conclusion possibly may be taken on the ground that it is not applicable in a case where one corporation owns all, or a sufficient amount of the stock of another corporation to direct the application of surplus profits, and periodically revalues its investment in the stock of the subsidiary company. Such circumstances seem not to indicate an exception to the rule which excludes appreciation from earned surplus. Revaluation on the basis of net asset values of subsidiaries, where warranted by circumstances of control, is but another way of giving expression to a result which would be achieved by consolidating the accounts of two companies. That this procedure may result in an amount of surplus greater
than that of the parent company alone, does not place the parent company in the position of having taken credit for unrealized appreciation.

The question may be raised, next, as to whether the procedure of increasing the book value of an asset, increases the capital account of an enterprise. The value of capital to an enterprise is determined by its earning power. Capital being but a collective term comprehending ownership of, or an equity in, the assets of an enterprise, the earning power inheres not in the capital account, but in the substance by which the capital is represented. To answer in the affirmative the question of whether increasing the book value of an asset increases capital, it must be shown that the asset which has been raised in value has increased earning power which justifies the value assigned to the asset.

Physical property in the form of buildings and equipment scarcely may be considered to be capable of producing any favorable effect on earnings. On the contrary, the older such property becomes, the greater, frequently, becomes the burden on earnings. Consequently, such property does not meet the test which justifies an increase in asset value and in capital.

Land, under certain circumstances of location and demand, may increase in value, but the increase is a theoretical one requiring an exchange in order to make it effectual. In the hands of the same owner and without improvement, usually it has no increased value in use.

Mineral deposits are analogous to land. Their value in use continues the same. Their value in exchange requires a transfer of ownership, before an increase in value may be recognized.

Values in ore bodies, or other natural resources, established by discovery and engineering appraisal, constitute an exception to the foregoing statement, in that they represent added wealth which finds its rational place in capital, and is justified by increased value in use, with the consequent effect on earnings.

Nature, also, is responsible at times for increment which it seems must be recognized. Probably no one would maintain that the natural increase in timber, livestock, or nursery-stock should be ignored in any attempt to portray, by means of accounting, conditions and operations of enterprises dealing in such resources. On the contrary, it seems but reasonable that the accretion should be admitted to a place in the inventory of assets, with the consequent effect, as the case may be, on capital, reserves for unrealized increment, or profits.

Coming finally to intangibles, it is apparent that some enterprises possessing rights under contracts which have been undervalued, or not previously valued, or having franchises, patents, trade-marks, copyrights, etc., acquired at nominal cost, may enjoy profits in excess of those which are normal for their particular line of business. Under such circumstances, it seems that the owner of such intangibles would be justified in attributing the excess profits to such assets, and in placing on them a value commensurate with their earning power. In cases where the increased earning power has been demonstrated to have continued over a reasonable period of time, and is sufficiently permanent to warrant it, it would not seem irrational to raise the book value of the asset and credit the amount of the increase to capital. The effect, incidentally, would be to adjust the future return on capital so that it would tend to conform to the rate assumed as the norm.

There are at times circumstances involving land which create a situation analogous to that in which the capitalization of intangibles is warranted. Where capital, represented by land at cost returns a profit substantially and continuously in excess of normal, it does not seem illogical to increase the land value and the capital so that the future percentage of return on the increased amount of capital will approximate a normal rate of return. This is not on the theory that the value of surrounding lands has increased and
created a possibility of sale at a profit, but that the owner, by reason of the increased earning power conferred on him by a fortunate purchase, is entitled to capitalize that increased earning power. Thus, it seems that the situation becomes analogous to that involving intangibles.

The preceding discussion of appreciation in its relation to capital seems to warrant the conclusion that an increase in the book value of an asset does not justify an increase in capital account unless the asset has increased value in use. Increased value in exchange does not constitute grounds for increasing capital.

Common law and specific statutes, in some jurisdictions, may deter those charged with the direction of corporate enterprises from paying cash dividends out of anticipated profits, or estimated surplus. There is little, if any, regulation, however, outside of that employed by the Interstate Commerce Commission and the various public service commissions, over the bookkeeping of corporations.

If a corporation desires to give expression to a theoretical increase in value of property, there is little an auditor can do to prevent such practice, except to inform himself thoroughly on the subject and exercise his logic and moral suasion in the premises. He can and should, however, refuse to certify to a statement in which the expression of increased value results in a misleading representation with regard to surplus, or to capital.

Justification of the practice of recognizing appreciation is attempted at times on the ground that the increase in value will be recovered out of future earnings through increased charges for depreciation.

This theory is fallacious, in that if the proportionate credit, representing a decline in unrealized appreciation, is properly applied, that is, as an offset to the depreciation charge, the net result will be the same as if depreciation had been taken on the property value before it was increased.

The effect of charging an increased amount of depreciation is to show the realization of a fictitious profit on property at the expense of future income. The result is doubly misleading. Net income from operations has not, in fact, been reduced; neither has a profit been realized through disposal of the property.

This argument is in no sense a criticism of the practice now prevalent of having property appraised by qualified appraisers. For purposes of insurance, appraisal is a proper procedure. For purposes of negotiation incident to a sale of property, or recapitalization involving the entry of new money into an enterprise, appraisal is pertinent and logical. For the purpose of creating a surplus to be distributed to shareholders in the form of cash dividends, appraisal is impertinent and unsound. If an appraisal relating to property which is subject to depreciation, is used to create a surplus which will be apportioned by means of a stock dividend, the procedure is not only unsound in that it erroneously assumes an increase in capital, but it is misleading in that it conceals the burden which is placed on future earnings through the increased depreciation charges which must follow.

The contention sometimes is made that the cost of replacing property having increased because of a rise in the general level of prices, property values should be marked up in order to protect invested capital against a sudden and unexpected charge in the event of severe property loss. Such procedure, being accompanied by an increase in the periodic charge for depreciation, has the advantage, it is claimed, of providing for the extinguishment of the property on the basis of replacement cost while protecting the original capital against impairment in case of extraordinary loss.

The fallacy in this theory, as it relates to capital, is that the property value will be extinguished with equal certainty on the basis of original cost and the corresponding periodic charge for depreciation, and capital will not become impaired. Depreciating property on the replacement basis is tantamount to anticipating an increase in surplus or in capital and attempt-
ing to make good the realization of the increase out of future earnings.

Directors who fear extraordinary property losses should arrange for insurance on the basis of replacement cost as long as such cost is above original cost. If directors consider it desirable to provide a reserve against extraordinary property losses, they should create it through a special charge against surplus, rather than misstate the net profits by excessive charges for depreciation.

If a corporation decides to increase its capital by means of an appraisal of property, perhaps no preventive can be imposed. Such steps should be taken, however, with the knowledge that if the property is of a depreciating character, the increased depreciation charge will result in decreased future net earnings in an amount equal to the depreciation on the appreciation. This effect is one especially worthy of consideration in its effect as between present and future shareholders. Those who buy shares, the capitalized value of which in part is based on appreciation of depreciating property, must expect to suffer the consequences of reduced future profits, and perhaps reduced dividends.

The power to prevent a corporation from writing up the value of its property, where prevention is desirable, obviously, is beyond the control of the accountant. But the right is his to determine the kind of financial statements to which he will attach his certification. It is his duty to refrain from certifying to financial statements which are misleading. Applying this formula, consideration may be given to the various treatments of appreciation in an attempt to discover what constitutes a misleading statement.

Property clearly described on the asset side of a balance sheet as being carried at appraised value should mislead no one. Intangibles so described should be equally clear. Earned surplus which contains an undisclosed element of appreciation is misleading, and the inclusion of appreciation under the general caption of surplus is a misrepresentation.

While it may seem sufficient in giving effect to appreciation to differentiate it from any earned surplus by showing it as "capital surplus," or "surplus arising from appreciation," all the reasoning heretofore applied seems to lead to the conclusion that appreciation does not, in fact, give rise to surplus of any kind. Under such circumstances, it appears that the credit for appreciation may not be described in any way on the balance sheet as surplus, without danger of misleading the reader.

Almost equally dangerous is the practice of including the credit for appreciation in the capital account, without disclosing the fact, in cases where corporations have shares of no par value. The implication exists, where such stock is involved, and there is no question of stated share value, that the capital account represents the amount of consideration received for the stock, plus such amounts as the directors have authorized to be transferred from surplus thereto. The inference may be drawn, therefore, that such capital is based on closed transactions, and is not dependent in any part upon future earnings for its establishment.

No one should be misled with respect to the credit for appreciation, in its relation to capital and surplus, if an amount equal to the estimated appreciation is placed in an account by itself, stated on the balance sheet in a separate caption above the capital stock, and appropriately described. A descriptive title which would be universally acceptable is difficult to find. Judging the matter from the standpoint of what must transpire if effect is to be given to appreciation, and it is to be treated correctly in its relation to the asset, to capital, to depreciation, to earnings, and to surplus, the element seems to stand out clearly as an estimated increase in value which has not been established by realization, or by earnings. Consequently, it may be described accurately as "Unrealized appreciation" or "Unearned appreciation."

The conclusions reached with respect to appreciation are as follows:

1. The recognition of appreciation in
accounts generally is unsound from the point of view of economics.*

2. Appreciation does not increase capital, except in cases of newly discovered value, and of increased intangible or other asset values which are supported by indisputable earning power.

3. Appreciation should not be recognized unless it is justified by newly discovered value, or by increased value in use. Value in exchange does not justify its recognition.

4. Appreciation is not recognized by the profit economy, which requires that there shall have been a closed transaction before gain or loss may be determined.

5. The recognition in accounts of appreciation as creating a realized and distributable asset value is contrary to common law, and to some statutory law.

6. Profits, ascribed to appreciation, are excluded from income which is subject to Federal taxation.

7. Appreciation does not give rise to surplus which may be distributed in the form of cash dividends.

8. Appreciation does not give rise to earned surplus.

9. Appreciation may not be shown as having given rise to surplus of any character, without danger of being misleading.

10. Appreciation should not be given effect in a balance sheet, except as an estimate of unrealized value, in the nature of a reserve which may be shown either on the side of the liabilities or as a deduction from the corresponding asset. If shown on the side of the liabilities, it should appear above the capital section of the balance sheet, and in any event should be described as "Unrealized appreciation," "Unearned appreciation," or by means of some caption equally clear and accurate.

11. The theory that appreciation may be recovered out of earnings by increasing the charge for depreciation is erroneous.

12. The amount corresponding to depreciation of appreciation periodically deducted from unrealized or unearned appreciation, in cases where effect has been given to appreciation, should be applied as an offset in reduction of the charge for depreciation, so that the effect on net profits will be the same as if the charge for depreciation had been based on the value of the property prior to the introduction of appreciation. Stated differently, depreciation of appreciation should be charged against "Unrealized appreciation."

Telephotographic Statement

Our New York Broad Street office recently sent a financial statement by the telephotographic system of the American Telephone & Telegraph Company to our Los Angeles office. This statement was a schedule of securities held by a New York bank for the account of a certain corporation, giving the number and market values of the various securities held on each of three dates. It was of considerable size, covering slightly more than one ordinary working sheet. The time required was approximately one and one-half hours from the time the statement was placed in the hands of the transmitter until it was delivered to our Los Angeles office. The cost of sending it by telephotograph was considerably less than it would have been to have sent it by telegraph. Obviously, the result was much more satisfactory. The New York Broad Street office was enthusiastic over their first experience in using the telephotographic process.

News Items

Colonel Carter and Mr. Kracke recently returned from Europe on the S.S. Majestic of the White Star Line.

Colonel Carter was reelected vice-president of The Accountants Club of America, at its annual meeting on November 19, 1928, at New York.

* A study of the subject of "Appreciation" by graduate students under Professor A. C. Littleton, in the College of Commerce and Business Administration, University of Illinois.
Mr. Reik is making a tour through South America, visiting our clients there, and the offices of Messrs. Deloitte, Plender, Griffiths & Co., with whom we are affiliated. At date of this writing, he is in Rio de Janeiro. His itinerary to date has been as follows:

S. S. Vandyck, October 27, left New York; November 17, arrived in Buenos Aires; from there to Santiago, Valparaiso, and Montevideo; and from Montevideo to Rio de Janeiro by steamer.

It is interesting to note that Mr. Reik had planned to leave Buenos Aires on the S. S. Vestris, which came to disaster while on its scheduled voyage from New York to Buenos Aires. From Rio de Janeiro, Mr. Reik expects to go to Sao Paulo and Santos, and sail from Rio de Janeiro on the S. S. Voltaire, January 6, arriving in New York, January 23, 1929.

Mr. G. P. Leonard and Mr. J. A. MacKinnon sailed from Vancouver, November 17, 1928, on the Empress of Russia, on an assignment to the Orient. Mr. Leonard will be connected with our Manila office, and Mr. MacKinnon will be on the staff of our Shanghai office.

Mr. Tilton, of our Detroit office, delivered a radio address over station WJR, on Tuesday, November 27, 1928, at 7:30 P.M., on the subject, "Duties of a Public Accountant."

Mr. Tilton was recently appointed by the president of the Michigan Association of Certified Public Accountants as chairman of the committee to formulate suggestions and cooperate with the Union Trust Company of Detroit in a program of publicity, setting forth the desirability of employing public accountants, which the Union Trust Company proposes to finance. The above address was a part of this program.

In a letter to The American Accountant, which appears in the December, 1928, issue of that magazine, Mr. Bell commented on the possibility of a wider use of the descriptive form of balance sheet.

Mr. Bell has been appointed a member of the Special Survey Committee on Inventory Verification of the New York State Society of Certified Public Accountants.

At a meeting of the Society of Certified Public Accountants of the State of New Jersey, on November 21, 1928, Mr. Bell spoke on the subject, "The Viewpoint of the Accountant on Accountants' Reports."

Mr. P. L. Shobe, of our San Francisco office, received the John F. Forbes Medal for 1927-28 from the California State Society of Certified Public Accountants, November 14, 1928. This medal is given each year to the individual who passes with highest credit the California C. P. A. examinations. About three hundred candidates were examined. Mr. Shobe is to be congratulated upon his success.

Our San Diego office has been moved to the John D. Spreckels Building.

Effective December 1, 1928, Mr. C. A. Gaylord, of our San Francisco staff, became manager of our San Diego office, and Mr. Paul R. Seng, of our San Diego staff, became assistant manager of the office.

Mr. P. C. Davis, manager of our Seattle office recently was elected secretary of the Seattle Arctic Club.

Mr. A. F. Wagner, manager of our Minneapolis office, presented a paper on "Classification of Services Rendered by Public Accountants" at a meeting of the Minnesota Society of Certified Public Accountants held on Tuesday evening, October 23, 1928, at the Minneapolis Athletic Club.

The supplemental report of the Special Committee on Arbitration of the American Society of Certified Public Accountants, of which Mr. Dunn is chairman, appeared in the November issue of The Certified Public Accountant.
The Profit Economy

In this age of uneasiness, when social, religious, and economic traditions are being challenged by thinkers, both profound and loose, it need not seem strange if accountants wonder what will be the effect of having so many other interests think about accounting.

The interests to which reference is made are represented by commercial bankers, investment bankers, credit men, comptrollers, lawyers, appraisers, engineers, statisticians, and statute-makers.

These forces, all with the best of intentions, sometimes have the appearance of seeking to mold and improve accounting, and some of them accountancy, because of the vital part these subjects play in matters with which they are concerned.

Each party, in his effort, approaches the matter from his own particular angle. Each has a background, peculiar to his experience. Each sees the problems through different eyes.

The result to the accountant who comes in contact with these various interests is a condition of bewilderment; of wonder as to how the divergence of thought will end; and of anxiety as to how he can compose and harmonize various differences of opinion, still preserving the traditions which guide him in his chosen occupation.

Statutes in some jurisdictions make it possible to violate some of the fundamental principles on which accounting is based. The commercial banker may argue for practices which are ultra-conservative.

The investment banker may not be criticized, perhaps, if he strives for a set-up which will show the best picture possible. The credit man wants to have things held down.

Comptrollers may wish to avail themselves of statutory provisions which are liberal to corporations. Lawyers, because of their training, usually can find authority in decided cases on either side of a controversy.

Appraisers have some advanced ideas with respect to values and depreciation. Engineers are apt to be precise and exacting. Statisticians sometimes have views which are novel and interesting.

Thus, accounting may be likened to a football, which the accountant tries to guide to its goal. The lot of the accountant becomes hard. Sometimes it appears little short of impossible.

But out of the darkness gleams one shining light at least. Business operates under what is known as a profit economy. The profit economy requires that there shall be a closed transaction before gain
or loss may be determined. If David Harum had tried to express this thought he might have said, "You can't make money doing business with yourself."

Sooner or later, it seems safe to assert, all the parties who are interested in accounting will have to agree on that fundamental principle.

The Certified Audit

(A special editorial appearing in the December, 1928, Monthly Bulletin of the Robert Morris Associates.)

The importance of having financial statements audited by Certified Public Accountants is being recognized more and more each year by both business men and bankers. An intelligent audit should be of direct benefit in the operation of a company's business through the detection of inordinate expense, waste, errors and fraud, and the introduction of speedier and more economical methods. The management should look upon the audit as a productive investment. Furthermore, a balance sheet certified to without qualification by accountants of ability and high standing is a strong confirmation of good credit standing, particularly when the management is not personally known. Many note-buying banks refuse to purchase the obligations of companies whose statements are not audited.

The value of an audit depends upon the quality and scope of the examination made by the accountants. Care should be used in the choice of accountants. There are a number of firms whose work and reputations are known generally to banks throughout the country; there are also many small firms and individuals highly regarded in their own localities who are capable of doing good work. There are other accountants whose certificates, because of careless and incomplete methods, weaken rather than strengthen the value of a report when used for credit purposes. The standing of accounting firms can easily be ascertained through interested bankers.

The work of accountants should not be unduly restricted. The scope of their examination should be such that they can give an unqualified certification. This is especially true in regard to the certification of and responsibility for inventories. The business man may well discuss with the accountant the proper verification of inventories before the audit is undertaken. A qualified certificate indicating that the accountant has not had free scope in his examination may do injustice to the borrower out of all proportion to the additional expense necessary to prepare a complete report.

An audit limited to an examination of cash, receivables and payables, and a checking of the footings and postings of the books may have a certain value to the management. A statement, however, in which a major item has not been substantiated can hardly be accepted unre­servedly by those on the outside who are entitled to an independent expert opinion regarding the fairness of the balance sheet as a whole. Some accountants are reluctant to undertake a restricted audit, which can end only in a qualified certificate, believing that such service cannot in the long run be beneficial to borrowers.

In order to certify a balance sheet without reservations as to inventory, the accountant has to satisfy himself that the quantities on hand and the basis of valuation, as well as computations, are substantially accurate and reasonable. The accountant will not insist upon taking stock or even supervising the stocktaking if the company has a well organized system and adequate accounting records from which he
can prove the essential accuracy of the inventory quantities. Manifestly, an accountant who makes a survey of the company's products, their distribution and the materials entering into them, as a foundation for his verification of the inventory, is better prepared to complete an intelligent audit of the other assets and of the liabilities.

Bankers have confidence in a financial statement supported by an unqualified certificate evidencing an unrestricted audit. A company cannot afford to have its credit jeopardized by the suspicions that may be aroused by qualified certificates or by employing accountants whose standards permit the use of an unqualified certificate with a careless or incomplete audit.

Comment

We are pleased to reproduce the foregoing editorial, particularly inasmuch as it stresses the thought that an auditor should be free, untrammelled, and unrestricted in his work. Obviously, every certified public accountant dislikes to have his work circumscribed, or to have limitations placed upon his services. On the other hand, all business concerns requiring the services of auditors have not reached the point where they are able to appreciate the advantages of full review, regardless of what they consider the particular need for the auditors' services. Consequently, as long as this condition continues, it need not be thought strange if those who employ accountants, offer for credit purposes what they have on hand in the way of financial statements. Further, it is possible that those who so use certified financial statements may attempt to obtain their lines of credit with a minimum of expense for auditing services.

Bankers, figuratively speaking, are the consumers of a large volume of financial statements prepared or certified by accountants. The bankers have learned from experience that there are various kinds of reports issued by accountants, and that various reports represent different gradations of services. The bankers have learned, also, that it is incumbent upon them to read and examine all of a given report before reaching a conclusion as to the value of the report.

The editorial reflects something of an evolutionary order which has been going on in the field of bank credit in so far as the services and reports of certified public accountants are concerned. Having reached a conclusion as to what they require from borrowers as a basis for their judgment in passing on credits, the bank credit men have, with characteristic succinctness, said what they want. It has been well said. The burden of satisfying the bankers as well as the client, in cases where the client places no restriction on the work of the accountant, might appear to rest with the accountant.

Check Forgeries and Alterations

Losses from forgeries and alterations it has been estimated occur in the following proportions:

1. Forgery of signature, 45 per cent.
2. Forgery of endorsement, 50 per cent.
3. Alteration of instrument, 5 per cent.

There often is some question in cases of this kind as to who shall bear the loss, the bank or the depositor. The legal responsibility is covered by the Negotiable Instruments Law, which has been adopted in substantially the same form by all our states.

The general rule in the case of a forged signature of the maker of a check is that the bank is liable. A bank must know the
signatures of its depositors. Where a signature is forged or made without authority of the person whose signature it purports to be, it is inoperative, and no right to retain the instrument, or give a discharge or to enforce payment against any party thereto can be acquired by such signature unless the party, against whom it is sought to enforce such right, is precluded from setting up the forgery for want of authority.

It makes no difference how perfect may be the forgery of the name of the maker. The bank is liable because it has made an unauthorized payment. Since the relation between a bank and a depositor is that of debtor and creditor, when a depositor draws a check, he instructs his debtor, the bank, to pay to a third person. The bank has no right to pay anyone except upon the authentic order of its creditor. It follows then, that when a bank pays a check not signed or authorized by the depositor, it is doing something which it has no right to do, and must suffer any consequent loss.

However, when a depositor holds out to the bank or others relying upon appearances that a certain person has authority to sign his name to checks, the depositor cannot set up a lack of authority on the part of the person signing. This situation rarely arises, because banks usually require the registry with them of signatures to be honored.

A depositor must use reasonable care and diligence in examining returned checks and bank statement, and in comparing such statement and checks with his stub book. Failure to exercise such care will preclude him from setting up forgery. A person using a stamp signature may suffer loss if he negligently allows others access to it.

The bank, as between the bank and the depositor, usually is liable for loss under a forged endorsement. Except in very extraordinary circumstances the depositor is not bound by any credit erroneously given by the bank to an endorsement. As stated in connection with forged signatures, the depositor must bear the loss where to all appearances he has held out that a certain person has authority to endorse checks for him or has been negligent in examining the bank’s statement of his account and his canceled checks.

Under the law a forged endorsement is “wholly inoperative” against the drawer or the endorser whose signature is forged and confers no right to retain the instrument or to enforce payment against the drawer of the check. Any person who is asked to cash a check has a right to inquire whether or not the endorsement is genuine. If the check is cashed, and subsequently it is found that the endorsement was forged, the party cashing the check has no action, except under the circumstances already mentioned, against the drawer or the endorser whose name was forged. Their remedy is against only the person who forged the endorsement. If there were endorsers subsequent to the forged endorsement, any holder can go back to a prior endorser as far as the forged endorsement, for reimbursement. A bank, it is evident then, cannot enforce payment against the depositor who is the drawer of the check, and its only right is against persons endorsing subsequent to the forgery.

Check alterations are few in number compared to forgeries. The depositor is not liable for an increased amount unless his negligence directly facilitates the alteration. The use of protective devices will avoid such losses. A depositor is entitled to use the ordinary form of check and to sign his name in ink in the form of signature filed with the bank. He is not required to use all known means of protection. However, the use of protective devices is to be encouraged, for anything which will help to prevent losses from forgeries or alterations to either a bank or its depositors is much to be desired.
Persistence in Claim for a Tax Refund
By H. W. Ellis, New York Broad Street Office

An interesting development in a federal tax case recently has reached the point of a satisfactory settlement, which illustrates the importance of persistently refusing to accept an improper decision from the Commissioner of Internal Revenue, and of fully considering the possibility of there being more than one basis of accomplishing the desired result when certain features of the case have to be abandoned.

The "M" Company and the "N" Company were not affiliated during the year 1919, but during the year 1920 they were affiliated and filed a consolidated return for that year. This return included approximately $75,000 net income of the "N" Company and the tax was paid upon the entire net income shown by this return.

It was later discovered that the "N" Company had sustained a statutory net loss for the year 1919 of approximately $105,000 which had not been taken as a deduction in the 1920 return. A claim for refund was therefore filed, and while the whole $105,000 could not be claimed as a deduction in the consolidated return, due to the fact that the company had not been affiliated with the "M" Company in 1919 when the net loss was incurred, it was recognized that this loss could be allowed as a deduction to the extent of the "N" Company's income of $75,000 which was included in the 1920 consolidated return. But, while the Commissioner allowed the deduction, he did so only in part, because in auditing the net loss for 1919 a disallowance was made for what was said to be "capital expenditures" amounting to about $50,000 thus reducing the statutory net loss from $105,000 to $55,000, which lacked $20,000 to eliminate the "N" Company's entire net income of $75,000.

A second claim for refund was therefore made, protesting the disallowance of the "capital expenditures" for lack of sufficient explanation and identification, and also making claim for depreciation of $45,000 for each of the years 1919 and 1920, which was admitted to be quite proper, but which had not been previously claimed. Either of these items would have eliminated the remainder of the "N" Company's taxable income of $20,000 for 1920 but for the fact that the second claim for refund was filed after the statute of limitations had expired. For this reason the second claim was entirely rejected by the Commissioner.

It was persistently claimed however that the "capital expenditures" could not properly be disallowed until they were more fully identified, and it was also urged that if the second claim must be rejected because of the statute of limitation, that the first claim be reconsidered and that these items be given effect in connection with that claim which had been filed within the statute of limitation. After much delay this appeal was also formally denied, upon the ground that no issues could be considered other than those mentioned in the claim.

A further demand was then made, either for a satisfactory explanation of the "capital expenditures" or that they be allowed as a deduction. The matter was considered again, but another formal letter of rejection was eventually received.

Still, we refused to accept this as final, and at a later conference the matter was presented in a different way, by claiming that even if depreciation had not been one of the points mentioned in the first claim for refund, the statutory net loss had been claimed, and that there was no reason why the computation of this net loss should not be correctly made by including depreci-
tion, which was a perfectly proper deduction in such computation.

It appears now that upon this basis an additional amount will be allowed by the Commissioner so as to eliminate all of the remaining taxable income of the "N" Company for 1920. The exact point which eventually proved to be successful therefore is, that while depreciation for 1920 could not be allowed as a deduction from income because it was not mentioned in the first claim, it could be allowed as a deduction for 1919 in the correct computation of a statutory net loss.

An Interesting Cash Shortage

By C. H. Ritchie, Minneapolis Office

A SHORT time ago our office had an interesting experience in discovering a shortage while conducting a general examination. We were engaged by an eastern client to make an examination of the accounts of a local company in connection with a proposed purchase of this local company.

The defalcation was perpetrated by the office manager, who had been employed by the company for about eight months, and, among other duties, kept the general ledger, the cash disbursement record, and purchase journal, and prepared and entered disbursement checks, but did not sign them. He also obtained the bank statements and reconciled the bank account.

The general manager of the company requested us not to divulge to the office force the reason for our examination. He further suggested that if we needed any assistance in our work to come to him, because the office manager had complained about the bother of having accountants at work again (about five months had elapsed since the completion of a previous audit), and had also remarked to the manager, "Let the auditors dig out what they want themselves."

As soon as we started the work, the office manager, contrary to our expectations, proceeded to make himself very attentive. He appeared to be greatly interested in our procedure, asked numerous questions regarding the methods and extent of our verifications, and requested us to consult him whenever necessary. Accountants always welcome coöperation, but, in this particular case, assistance was volunteered so often and so profusely that it became a hindrance and nuisance rather than a help.

The first indication of an irregularity appeared when taking the general ledger trial balance, which was done shortly after starting our work. In taking this trial balance, we used the differences between the debit and credit footings of each account instead of the pencil balances usually found in general ledgers. This procedure resulted in a discrepancy between our figures and the company's in the bank balance. In attempting to locate this difference, we found other errors in footing the bank account in the general ledger. The aggregate of these errors, it later developed, constituted the amount of the shortage. We also found that these understatements of the bank accounts were offset by a fictitious charge to "machinery," and an underfooting of the credit side of the accounts receivable control account in the general ledger.

It is perhaps needless to say that these irregularities directed our suspicions toward the office manager, and compelled us to refrain from partaking of his profusely offered assistance. If any circumstance arose about which we desired information, we consulted the general manager of the company, who had been advised of the errors previously described.
Several days later we made an interim cash verification, obtaining a special statement of the bank account. Our bank reconcilement, which took into account the errors previously noted, showed again that the bank balance according to the books was understated by the amount of the errors, which, of course, positively indicated a defalcation but did not furnish evidence of the method of perpetration or prove definitely who was the defaulter.

In order to determine the exact dates and amounts of the shortage, we requested the general manager to accompany us to the company’s bank so that we might examine the bank’s ledger sheets. Upon our return from the bank, the general manager found a note from the office manager in which the shortage was admitted. Later a sworn confession was obtained.

The defalcation was perpetrated in two ways. One method, used only during the absence of the general manager, was the issuance of pay-roll checks to fictitious employees. The other method comprehended raising the written figures of regular disbursement checks, properly signed and entered. In this case, the discrepancies between the written figures and the protectograph amounts were apparently overlooked by the paying bank. All of the irregular checks were destroyed.

This particular shortage, though of a comparatively small amount, was perhaps not unusual in the methods of perpetration, or in the manner of attempted concealment. However, the shortage was “covered” on the books by understating an asset, and the arrangements with our eastern client did not comprehend an audit which would disclose understated assets. The case is, therefore, interesting in demonstrating again that even relatively routine tasks, if done carefully, and with thought as to their purpose, may furnish unexpected clues leading to the discovery of a shortage.

Additions to the Library


— *Operating Expenses of Plumbing and Heating Supply Wholesalers in the Central States in 1927.* (Boston, George H. Ellis Company, 1928. 35 p. Bulletin No. 71.)


— *Operating Results of Retail Jewelry Stores for 1927.* (Boston, George H. Ellis Company, 1928. 22 p. Bulletin No. 76.)


Schmalz, Carl N. *Standard Departmental Stock-Sales Ratios for Department Stores.* (Ann Arbor, Univ. of Michigan, 1928. 62 p. Michigan Business Studies.)
News Items

Mr. Bell has been appointed a member of the American Institute of Accountants, Committee on Placements.

Mr. Bell gave an address on December 19, 1928, before the Queens Branch of the New York Credit Men's Association on the subject of "Financial Statements for the Credit Man."

Mr. Coursen, of our Newark office, has been appointed chairman of the Committee on Ethics of the Society of Certified Public Accountants of the State of New Jersey. Mr. Coursen also was appointed to membership on the Committee on Lecture and Entertainments.

At the New Orleans meeting of the American Society of Certified Public Accountants on October 11, 1928, Mr. Dunn discussed the topic of arbitration, following an address on "Arbitration as Applied to Business Disputes," by Monte M. Lemann. This address and Mr. Dunn's discussion appears in the December, 1928, issue of The Certified Public Accountant.

Mr. O'Connell, of our Saint Louis office, has been appointed a member of the Committee on Legislation of the Missouri Society of Certified Public Accountants for the year 1928–1929.

Mr. Rossetter gave an address on "Public Accounting as it is in 1928" at the quarter centennial celebration of the Illinois Society of Certified Public Accountants in the Gold Room of the Congress Hotel, Chicago, on Tuesday, November 13, 1928.

The December issue of St. John's Analyst contains an article by Mr. M. A. Finnen, of our New York 39th Street office, entitled "Books versus No Books."

Mr. Walter E. Curt, of our Berlin office, has been appointed assistant manager of that office, effective January 1, 1929.


Messrs. B. C. Hightower and J. S. Wallace, of the Chicago office staff, became assistant managers on January 1, 1929.

Mr. C. F. Hadden, of our Denver office, was successful in passing the November examination of the American Institute of Accountants for the Colorado C. P. A. certificate.

Mr. H. T. Hagren, of our Newark office, recently passed the C. P. A. examinations for the State of New Jersey.

Mr. D. P. Musselman, of our New York 39th Street office, has been notified that he passed the November, 1928, examination and has been recommended for the C. P. A. certificate of the State of Pennsylvania.

Miss Palen, of our New York Broad Street office, has written a chapter on accountancy as a career for women in a book entitled An Outline of Careers for Women, published by Doubleday, Doran & Co.

Mr. Milon M. Stone, of our New York 39th Street office, has been appointed a manager of that office, effective January 1, 1929.

Mr. W. M. Trant, manager of our Denver office, recently was elected a director of the Colorado Society of Certified Public Accountants.
Business in the Future

"Peace-pacts" and "cruiser-programs" are terms which, to the business-man, thinking about sales volumes and net profits, may seem to be little more than newspaper headlines. Individually, business-men may appear to be little concerned with agreements to outlaw wars, or legislation to afford additional naval vessels. Collectively, their future may be more closely bound up with cruiser-programs than appears on the surface.

American business-men, individually and collectively, have a real interest in continued prosperity. A continuance of the standards of living to which North Americans have become accustomed requires a continuance of the present era of prosperity. The continuance of this prosperity is dependent upon an effective demand for the goods which North American industry of necessity must produce in order to give employment to the people of the country and to its capital.

There need be nothing boastful in the statement that this country is faced with the utilization of a capital fund greater than the world has ever known. With pardonable pride Americans may point to scientific methods and labor-saving devices which her industrialists have developed to an amazing degree of effectiveness. The result of this condition of affairs quite naturally, of course, is mass production.

The effect of mass production is likely to be an increasing supply of goods in excess of the purchasing power of the American public. Notwithstanding the fact that the purchasing power has been expanded by an unprecedented increase in instalment plans, a time must be reached inevitably, it seems, when the United States will have a surplus beyond the power of her people to absorb.

With no desire to be prophetic, present tendencies indicate that this country is destined to depend for continued prosperity on being able to place her exportable surplus abroad. The under-absorption experience of 1920–21 should make this clear. Recently published figures show the excess of exports over imports for the year 1928 to have been $1,039,000,000.00, an increase in the excess, compared with 1927, of over 50%. An exportable surplus without ships and protection to shipping is like having a supply of fur coats for sale in the Samoan Islands.

Peace-pacts and cruiser-programs, as complementary national policies, may appear incongruous to some. Perhaps, America's continued prosperity would have been assured without a cruiser-program. Who can say that it will be menaced by having one?
As the economic demands of the world compel the searching out and development of new fields for the use of capital, so must public accountants follow and be available to serve business, first, with the "shock troops" of capital in the investigation of investment possibilities, and later, in safeguarding the employment of capital and in verifying the accounting for its use. The extent and continued growth of the practice of our firm requires our presence (either through our own established offices or through the representation of and affiliation with other public accounting organizations of world-wide reputation), not only in South America but practically in every country on the globe. In the fall of 1928 the firm considered that the time had arrived when we should become better acquainted by first hand knowledge and information with the development of certain of the South American countries. Hence, my visit to Brazil, Uruguay, Argentina, and Chile, with port calls at Barbados and Trinidad in the West Indies, covering the period of approximately three months from October 27, 1928, to January 23, 1929.

At the mere suggestion of a trip to South America, involving days of passage through the equatorial region, one naturally thinks of a number of handicaps. But life is replete with compensations, and, in spite of its "ups and downs," travel in the tropics (on land as well as sea) is not necessarily a hardship. Travel facilities between the Americas, North and South, are very good and are being constantly greatly improved, sailing schedules are ample, and the steamer accommodations are more comfortable than might be expected, although facilities for railroad travel on land are not as extensive as we are accustomed to find at home. Nevertheless, to the extent to which rail facilities are available, and that covers a great many of the most important points, the service does not suffer from the lack of modern and comfortable equipment.

If a trip is prescribed for business or pleasure purposes, especially during the Northern winter season, let us say from the snow and ice-bound region of Niagara to the warm sunshine and the glorious moonlight of the tropics, can one say that the "medicine" should be a subject for complaint? Some there were who considered me lucky to have the opportunity of making this trip, and they and others considered me luckier still to have safely returned, and numerous inquirers have asked if I carry a rabbit's foot for luck. Admittedly, I was fortunate in my travels to have missed by one trip being a passenger on an ill-fated vessel which sank during my voyage south; to have crossed the Andes Mountains westward by train on the last trip immediately before and returned eastward on the first trip immediately after a serious washout and landslide which caused a suspension of all rail transportation on that line for nearly one week; and not to have suffered any physical injury nor to have entirely succumbed to fright during a series of earthquake shocks in Chile, in which I was an unwilling participant. I am not particularly reliant upon tokens of good luck and do not carry a rabbit's foot, because, for one reason, I cannot overlook the fact that at one time such a talisman must have belonged to an animal which had four of them, and certainly it did not bring him any good luck. Whatever the element of luck or fortune, the trip will remain a never-to-be-forgotten event.

The lesson in geography itself was almost worth the trip. With apologies to Ripley, but in true "Believe it or not" style, how many of us know that the distance is
14,000 miles from New York to Valparaiso and return by the East Coast route; that in rounding the easternmost point of Brazil one is halfway across the Atlantic Ocean; that the climate in the Zone of the Equator is pleasant to live in; that in area Brazil occupies 45% of the South American continent and is equal to that of the United States (without Alaska), England, Ireland, Scotland, Wales, the Netherlands, Belgium, Switzerland, and Portugal combined; that the area of Uruguay exceeds that of New England; that the longest stretch of absolutely straight line of railroad track in the world is on the Trans-Andean railroad in Argentina—175 miles without a suggestion of a curve; that the highest mountain peak in the Western Hemisphere and the second highest in the world is Aconcagua in the Andes, and, not the least important, that the colonial beginnings in Spanish America are more than a hundred years older than ours? These and many other points of interest and knowledge are to be learned by a visit to the Far South, of which part of the world we are, perhaps, destined to hear more than of the Far East during the next few decades.

If one contemplates a trip to South America for business or pleasure, or if interested merely in increasing one's knowledge of its history and development, inquiry of any good library or book dealer will disclose an extensive bibliography, much of which is of recent origin and entirely reliable. Also, there is a wealth of statistical data available through the Bureau of Foreign and Domestic Commerce of the United States Department of Commerce, and much general information through the columns of the monthly magazines published in English under the auspices of the American Chambers of Commerce for the several countries of South America.

Every visitor to South America and everyone else who has an interest there, no matter how remote it may be, should become acquainted with the principal characteristics of the several political subdivisions of the continent and of their inhabitants, and this knowledge may be readily obtained by a moderate amount of reading of available literature.

The universal language throughout South America is Spanish, except in Brazil where Portuguese is spoken. In the best hotels one can manage fairly well with English, but travel in the interior presents many difficulties and embarrassments unless one has some familiarity with the native language. Always, in one's travels, courteous treatment is the rule, although it is natural that language limitations will occasion some misunderstandings. The educated classes have assumed a national dignity which at times is most painfully in evidence and causes them to attribute ulterior motives to the most innocent statements of other nationalists. In particular, they have an intense resentment against what they believe to be the paternalistic attitude of the United States. They bitterly oppose any hint that they are our "Little Brothers" needing the protection of a Monroe Doctrine, and eternal vigilance is required to see that this feeling is not unnecessarily aggravated.

The scenic beauties of the South American countries beggar description except by an artist. The bleak snow-capped mountains of the Andes, which may be crossed by rail at an altitude of nearly two miles, afford views which it is claimed, and apparently with abundant justification, cannot be excelled elsewhere in the world; the harbor of Rio de Janeiro is claimed and generally admitted to be the most beautiful in the world; and most of the large cities have clubs, parks, boulevards, and theatres which surpass those to be found anywhere in North America. The climate generally is sufficiently warm to be conducive to languor, but nowhere is there evidence of slothfulness. The na-
tural benefits of the climate are evidenced by the agricultural productivity, by the abundance of fruits and flowers, and, in the more tropical sections, by the magnificent ocean bathing beaches. Incidentally, it was possible to enjoy out-door swimming in the tank erected on the steamer deck until within two days of New York on the return trip in January. At Barbados the multitude of divers for coins always provides interesting entertainment for the passengers on ships at anchor there. One intrepid fellow, for a compensation of one American dollar, dived from the uppermost deck of our ship, swam under the ship, and came to the surface on the opposite side. It was agreed that he earned that dollar.

In all of the large cities of South America the conventionalities in dress are observed quite as they are in other large cities of the world, with a noticeable emulation of Paris, for example, but one does not pass far from the beaten track nor into the great "open spaces," particularly in the warmer climes of Brazil and the West Indies, without being attracted by the practical methods adopted in the struggle for comfort in dress—sometimes without much regard for what their distant neighbors may thinks of their ideas of modesty. Mr. Kipling's comments anent Gunga Din might not inappropriately be applied to some of the natives:

"The uniform 'e wore
Was nothin' much before,
An' rather less than 'arf o' that be'ind."

President-Elect Hoover's recent visit to the Latin American countries has been of great mutual benefit to the peoples of both continents, and, by reason of its timely arrangement, has brought to the entire universe some intimate knowledge of the peoples of those countries and their present-day activities. It was aptly pointed out by Mr. Hoover, in a speech in Brazil, that international commerce is the life-blood of modern civilization, and that the high standards of living now prevalent have created demands which make the interchange of products between nations an absolute necessity, not a luxury. For example, unless our country imported from tropical countries, we would not have automobiles, telephones, radios, electric lights, and hundreds of other articles which Americans feel they cannot do without.

Of the countries which I visited, Brazil is by far the largest in area and in population. It has approximately forty million inhabitants. Its two principal cities are Rio de Janeiro, with a population of about one and one-half millions, and São Paulo, with a population of about one million. The latter city has had a remarkably rapid growth in recent years, and is generally referred to as the Chicago of South America. There is also Santos, a city of about one hundred thousand inhabitants, which is the largest coffee shipping port in the world. Argentina has a total population of about ten millions, of whom about two and one-half millions reside in Buenos Aires, which is the largest city in South America and is proud of its resemblance to Paris. The total population of Chile is about four millions. Its largest city is Santiago, which has about five hundred thousand inhabitants, and its second largest is the seaport of Valparaiso, which has about two hundred thousand inhabitants. Uruguay's population comprises about two millions, and approximately five hundred thousand of them live in the city of Montevideo.

The members of the English and American colonies in South America do not comprise a very large proportion of the total population, but the English-speaking colonies are steadily increasing in numbers. In all of the larger cities they have their own town and country clubs, which provide a most interesting phase of social life, and they have accomplished wonders in
awakening and promoting the interest of the native inhabitants in all branches of athletics and sports. Throughout South America may be found some of the finest clubs in the world. Without attempting to present an inclusive list of the clubs, nevertheless, it would seem not to be amiss to mention the Jockey Club in Buenos Aires (perhaps the richest club in the world); the Hurlingham Club, just outside of that city and devoted primarily to athletics; the many very fine boating clubs situated along El Tigre River; the Union Club in Santiago, designed to surpass in luxury any other club house in South America; the Viña del Mar club located in the beautiful suburb of that name just outside Valparaiso; the Automovel Club in São Paulo; the Jockey Club in Rio de Janeiro; and many other English or Anglo-American clubs in each of the principal cities. While it is important that visitors to South America should not fail to see these delightful clubs, to permanent or semi-permanent residents they are an absolute necessity.

As the marvelous natural resources of South America are developed, and as such development is hastened and increased by the employment of foreign capital and modern methods, it is but natural that the population and wealth of those countries should rapidly increase. Banking facilities for American business have greatly increased since the World War, and at the present time several of the largest banks in the United States are represented in South America by branches which compare favorably in every way with those of the great banks of other nations which have been longer established there.

The trade of the United States with Latin America in 1925 amounted to more than $1,900,000,000.00, or 21% of our total foreign commerce, divided into slightly more than $1,000,000,000 of imports and slightly less than $900,000,000 of exports. The exports from the United States, in the order of their value, were cotton goods, iron and steel wares, petroleum products, grain and flour, automobiles and parts, lumber, lard, agricultural implements, electrical machinery, chemicals, and manufactures of leather, rubber, etc. Of the five leading imports of the United States (raw silk, sugar, coffee, crude rubber, and wool), nearly all of the sugar and coffee and large quantities of rubber and wool come from South America.

Since the World War American exports to Brazil have tripled and imports from Brazil have more than doubled. Brazil produced in the season of 1927-28 over 28,000,000 bags of coffee, or 78% of the world production. Coffee constitutes 75% of the total value of Brazil's exports. In connection with the rubber industry it is interesting to note that development of the Henry Ford rubber project on the Topajos River in Brazil has started. The rapid growth of the province and State of São Paulo is illustrated by the facts that from 1910 to 1925 the income of the state grew from 43,000,000 milreis to 353,000,000 milreis, or more than eight times, and that exports from Santos, which is the chief seaport of the State of São Paulo, grew from 282,000,000 milreis to 2,192,000,000 milreis, or nearly eight times, and that nearly one-half of the increase in each occurred during the last five years of the period, that is from 1920 to 1925. The total foreign investment in Brazil at the close of the year 1926 has been estimated at $2,500,000,000. Considering the heavy influx of American capital into Brazil since that year, the total investment of foreign capital in that country now is unquestionably much greater. Brazil is somewhat farther advanced than her sister republics in the building of good roads, and the carrying out of her program for road building should help greatly in the early development of the natural resources of the country and in attracting additional foreign capital for that purpose.
Argentina imports more from the United States than from any other nation. Of the automobiles sold in that country 95% are of American make. In 1909 Argentina imported less than 900 United States motor vehicles, but in 1927 imported nearly 45,000 and the estimate for 1928 is 65,000. In 1927 Argentina ranked as the second most important export market for United States passenger cars, and this despite the fact that because of the absence of good roads their use is almost limited to Buenos Aires and a few of the largest towns in the country. Argentina also imports a large quantity of agricultural equipment. The principal products of the country are meat and grain and its principal exports to the United States are linseed, hides and skins, wool, and quebracho. The Argentine freezing plants rival those of any other place in the world. During the four years from 1910 to 1913 Argentine imports from the United States averaged 62,000,000 gold pesos annually and her exports to the United States averaged 27,500,000 gold pesos annually. During the eight years following the World War the imports increased to an average of 240,000,000 gold pesos and the exports increased to an average of 110,000,000 gold pesos.

Chilean imports from the United States practically outstrip those from all other nations combined. Chile buys from the United States about $250,000,000 of products every year and sells to us about twice that amount. The copper, nitrate, and iron ore industries of Chile are for the most part in American hands, as also at this time are most of the electric power generating plants in central Chile.

The chief products of the British island of Barbados are sugar and sea-island cotton, although bananas, molasses, tropical fruits, etc., are also produced. Trinidad, the most southerly of the British West Indies, is a large producer of cacao, sugar, and coconuts, and is famous for its natural asphalt lake, which is leased by an American company. This is the world’s greatest asphalt supply.

The legal requirements in respect of business transactions in South America are numerous and frequently decidedly onerous, and, to add to the general complexity of the situation, they differ in many essentials in each of the several countries. It should not be forgotten that, although there is a United States of Brazil and other confederations of states in South America, there is not a United States of South America, and each of the several countries is at least as independent of thought and as jealous of its prerogatives as are nations in any other part of the world. It would be well for American business enterprises which contemplate ventures into South America to first confer extensively with capable advisers regarding the local regulations and requirements both precedent to and during the continuance of activities. Matters requiring the most careful consideration, for example, are the decision as to the form in which business is to be conducted; its registration and the cost thereof; the periodical publication of financial reports; the registration of trademarks, trade-names, patents, etc.; the numerous taxes to which business is subjected; the necessity for the use of certain books of account which must be officially approved and stamped by the government before entries are made therein; the requirements in some countries for sending to all purchasers duplicates of invoices which must be accepted and returned to the vendor within a limited time in order to constitute a legal basis for action to recover the debt; the necessity for the use of sales stamps and documentary stamps; and the advanced legislation in respect of the employment of labor—particularly the laws dealing with age limits of employment, maximum hours of employment, contributions to pension funds, ages of retirement, and bonuses payable upon discontinuance of employment. These are but
a few of the legislative handicaps to foreign business, designed, doubtless, from good motives, but none the less objectionable on the part of business which has not been accustomed to such restrictions. These matters coupled with the slow-moving, cumbersome, and, in some instances, political influence, methods of governmental contact with business activities, make it of vital importance for foreign businesses to be well informed before undertaking ventures in South America and well represented after starting them. And, in the matter of representation, too much importance cannot be placed upon the advantages of knowing the local language and at least something of local conditions, laws, and customs. Perhaps, it is also worthy to note that ordinary American “push” methods of salesmanship and advertising are looked upon in South America as undignified and somewhat of an affront to native pride. It is therefore of great importance to study the local mind, and in salesmanship and advertising to apply those methods which will attract rather than antagonize.

Under the continuance of favorable governments and circumstances, the resources of the South American countries and trade relationships with those countries are susceptible of profitable development, but their development is not unmixed with dangers and risks and justifies careful preliminary investigation and constant after-attention.

An article by Mr. Francis R. Hart, in the Harvard Business Review, contains an admirable summation of the difficulties which may hamper the development of steady and commercial relations between the United States and South America, and the following is quoted from his article:

“First as to the United States:

“1. On our part we need to overcome our fear as to the instability of a few of the governments; or, at least, to learn to discriminate between those concerning which there may be reasons for fear and those which have become relatively stable. The more responsible position the Latin-American countries have attained, and their increased dignity in the family of nations, have made the investment of foreign capital within their boundaries much safer than those persons with little knowledge of these countries realize.

“2. Our people have had little experience in foreign trade. We do not adapt our minds easily to the point of view of the other man. We have not learned to think internationally; we have the urge to sell but do not realize the correlative necessity to buy. The urge itself comes upon each industry intermittently; we wish to get into the foreign market when our home demand is satiated, and get out when it suits us. We have not learned the value of continued foreign trade relationships endured with mutual good-will during times of fulness and of trouble.

“3. We fear the foreign policy of our own Government; in fact, we are uncertain what it is. Each succeeding administration has had a new, or at least different, policy from the preceding one. We recall the “Big Stick” of Roosevelt and the Saratoga speech of Wilson. We have been on somewhat uncertain ground between the two.

“4. We fear our own laws, and are not sure that we know just what they mean in respect to foreign trade. The obtaining and holding of a foreign market for the products of many industries often require a co-operative effort and understanding between manufacturers, without which European competition might not be successfully overcome. We do not know to what extent this co-operation, when applied to the problems of importation and ocean transportation, is in violation of our national laws and policy.

“5. We realize, but do not attempt adequately to overcome, the handicap of our ignorance of the needs, laws, customs
and credits of our Latin-American customers.

"On the part of Latin-America:

"1. There is a very general fear of what they believe to be imperialistic policy of the United States. They are not sure that we are to be trusted. Does our release of Cuba or the Panama episode correctly reflect our aspirations? Are we sincere protectors of the weak, or are we hypocrites? Which of these did the conquest of Texas illustrate? Are we sincere in our protestations in respect to Haiti and Nicaragua, or have we a deeply hidden policy? If we are as honestly desirous to help the Latin-American countries as we profess, why did we, during and after the war, adopt a hypocritical policy towards the actual Costa Rican Government? Does the Monroe Doctrine mean to us that Europe must keep out, but that we may step in? Or does it mean, as they believe it should, that the states of America, inter alia, shall respect as inviolable the territory of each other? They know what we say, but are still uncertain as to what are our intentions.

"2. The introduction of American capital in a large way for great commercial developments in the way of transportation, oil, and farming hurts their pride. They welcome the benefits, but, regretting their own insufficiency, they resent the invasion from outside. Particularly is this so in regard to capital from the United States as its possible corollary, official intervention, is a nearer danger than with British or German undertakings.

"3. Their past experiences make them doubt the continuity of trade relations established with us. In many cases the responsible principals have not met and become acquainted. The old aloofness, although on the road to disappear, has not wholly gone.

"4. There is not yet the full correlation as between the three chief factors of international trade relations; exporting, importing, and banking.

"5. Our assumption of what we are pleased to call the part of a ‘Big Brother’ has a quality of condescension which is galling to the pride of peoples who value their own culture beyond ours, and whose colonial beginnings on this Continent antedate ours by a century."

The author quoted above further states that if difficulties are known and can be appraised, and if the need and wish to overcome them is mutual, they can be overcome. That this will happen to the advancement of trade relationships between North and South America, and on a mutually satisfactory basis, is a certainty.

America’s Interest in the Reparation Conference
By George P. Auld, Former Accountant-General of the Reparation Commission

The reparation negotiations now being conducted in Paris by the Young Committee are of large practical consequence to this country in our international relations and our domestic affairs.

The subject matter of the conference is one which ever since the war has had the most important effects on the political and economic life of Europe, and we can hardly fail to follow with absorbed attention, the writing of a new chapter in this great controversy.

As an exporting nation of the first magnitude, we cannot remain unaffected by the outcome of the conference. Annually we ship abroad five billion dollars’ worth of the products of our factories, farms, forests, and mines. These exports, of which Europe takes nearly half, amount to seven or eight per cent. of our total production. This represents a highly important proportion of our activity, and any substantial decrease in it would throw our industries into the doldrums. Five years ago our Euro-
pean customers were quarreling bitterly over the reparation question, and the ill effects of the dispute were felt in almost every department of their political and economic life. With the adoption of the Dawes Plan, there followed a period of remarkable political appeasement and economic recovery, and today a new group of skilful practitioners of international finance is preparing a modification or completion of that plan, looking to a new era of advanced convalescence in Europe.

Our second large economic interest in the settlement obviously lies in our stake as investors in European securities. This stake is an important one, though possibly not of the dimensions which common opinion assigns to it. In a study of mine in the January Annals of the American Academy (Philadelphia) it is suggested that the conservative estimates of the Department of Commerce relating to the amount of our foreign holdings deserve to be given great weight, despite the existence of other estimates of considerably larger size. The mean of the Department's estimates, as of January 1, 1928, indicated about three and one-half billion dollars invested in Europe. This figure of our gross holdings, moderate as it is, is substantially offset by nearly three billions of our own securities held by Europeans (our total world investment being estimated at twelve and one-half billions, and the total offset for foreigners' holdings here at three and three-quarter billions, leaving a net foreign investment of eight and three-quarter billion dollars). In addition, there are, of course, the inter-ally debts, the discounted value of which, at four per cent., as determined by the United States Treasury, is 7.47 billion dollars.

One reason for not lightly dismissing these relatively low estimates is this: The total of our yearly balances of exports over imports (including invisible items), since we started in 1915 to liquidate our then debtor position of about four and one-half billion dollars, falls short, by over four billion dollars, of indicating a present foreign investment of even the size estimated by the Department of Commerce. The invisible items in these estimates of our trade balances (which for the past several years have been compiled by the Commerce Department) are admittedly very difficult to determine. Nevertheless, the discrepancy still has to be accounted for, and further point is given to it by the statement of the Department that other compilers who reach higher estimates of our foreign holdings, have not taken sufficient account of "back-wash" or resales and redemptions of foreign securities, subsequent to the sale of the original offerings in our investment market.

The net figures, after offsets of this nature, are seldom published as conspicuously as the periodical announcements of the considerably larger gross figures of foreign issues taken here. The par value of such issues, in each of the years 1927 and 1928, amounted roughly to one and one-half billion dollars. The net figure for 1927, however, after estimated "back-wash" and increase in foreigners' holdings in the United States, was only seven hundred million dollars (the 1928 net figure not being yet available).

Carrying gross figures in our minds, and having no long tradition of foreign investing back of us, we seem, from time to time, to suffer from a certain nervous apprehensiveness, which is not, in fact, justified. We shall perhaps eventually learn to measure our foreign investments by the yardstick of England. British earnings in 1927 from such sources, according to their Board of Trade reports, amounted to 1.35 billion dollars, which is six per cent. on a principal sum of twenty-two and one-half billions.

This business of investing our surplus funds abroad, though perhaps less in annual amount than we have recently been accustomed to believe, is nevertheless of
great importance. It is becoming of increasing consequence to us that Europe remain a good credit risk. One reason, of course, is that we want our present loans paid at maturity. But, broadly speaking, that will unquestionably happen, whatever temporary disturbances arise in Europe. The continuous year-to-year peace and prosperity of Europe are important to us, because we cannot afford to have any interruption occur in the continuous placing of our surplus funds abroad. Upon the new loans (though, in fact, hardly less upon the expenditures of our tourists abroad) the maintenance of our export trade depends. These new loans provide our foreign customers with the dollars necessary to pay for our surpluses of exports over imports.

What, then, will be the effect of the new reparation settlement on these varied interests of a material nature which we have in the stability of Europe? If the conference has a successful termination—and the prestige, experience, and practical sagacity of its members make such an outcome probable—Germany's now indeterminate reparation liability will be definitely fixed to the reasonable satisfaction of all parties concerned, the present foreign control in Germany will probably be relaxed and the framework of a scheme for the future marketing of reparation bonds may perhaps be provided.

Such a series of accomplishments will not only constitute a distinct advance in the formal position of the reparation problem; they will also result in a substantial easing of the tensions which, in some measure, still remain over from the great conflict. In short, we may hope that the new settlement will strengthen the psychological foundations upon which the peace of Europe rests, and will give added vigor to the functioning of a normal economic régime.

Preferred Surplus
By John R. Wildman

A recent decision in the Wabash case (Barclay et al v. Wabash Railway Company), affecting as it does the matter of dividends, again calls attention to the possibility in the future of a change in the cardinal principle which long since has guided accountants in considering the relation of dividends to surplus. The principle is, that dividends are chargeable against surplus only when declared. The decision in question, if affirmed ultimately by the United States Supreme Court, will challenge seriously continued adherence to that principle, in cases where there are preferred shares.

A characteristic of dividends is that they are spontaneous; that they do not accrue like interest, but set up a right to surplus on the part of the holders of shares, only when declared. This principle holds even though shares carry cumulative rights, the effect of which is to deny to the holders of junior issues any dividends until all accumulations in favor of preferred shareholders have been satisfied.

The courts generally have been disinclined to dictate to directors with respect to dividends, and to leave to their judgment the question of whether or not surplus should be so distributed. Occasionally, accountants have been required to interpret certain passages in certificates of incorporation where dividend provisions seemed to make dividends akin to interest and to decide whether or not surplus should be assigned to shareholders regardless of action by directors. Generally, the prevailing rule has been that no charge against surplus should be made, notwithstanding the existence of a cumulative right, until directors have authorized the charge by declaration of the dividend.
The rights of preferred shareholders whose stock is cumulative with respect to dividends is clear under the foregoing theory. Whether or not there are profits, or surplus available for cash dividends, the annual dividend rate or amount accumulates and must be satisfied before any distributions to junior shareholders may be authorized. This, however, is but a right of priority in dividends, when, as, and if, declared. It is not an assignment of surplus.

If there are profits in a given year, sufficient to liquidate the claims of cumulative preference stockholders as to that year, but a dividend is not declared out of such profits, the claims of these stockholders for the year in question carry over, and the theoretical effect is to have a preferred surplus, although practically no such segregation of surplus is made.

If there are any profits in a given year, and no other disposition of the profits is made, leaving some amount available for dividend declarations in favor of cumulative preferred shareholders, but no such dividends are declared, theoretically, there is a preferred surplus; practically no such interest in surplus is recognized in so far as accounting is concerned. This statement should be modified, perhaps, to the extent of adding that it is customary to note any accumulation of preferred dividend rights at the bottom of balance sheets.

If there are no profits in a given year, or if there have been no profits in any year since inception, the rights of cumulative preferred shareholders carry on. But there can be no interest in surplus, either actual or theoretical, under the latter status; all of which suggests the fallacy of apportioning surplus without action precedent by the directors.

Until recently it has been thought that there was no necessity to consider any rights of non-cumulative preferred shares in profits which might be earned in a given year, but not declared out as dividends. The issuance of shares with non-cumulative preference rights as to dividends doubtless carries with it the implication of intent to compensate those who so furnished capital to the enterprise, at a given rate, in each year, contingent upon the earning of sufficient net profits to justify the disbursement of such compensation, without detriment to the enterprise. But the decision as to whether or not such disbursement may be made, necessarily must rest with those to whom is entrusted the management of the enterprise. Thus, if the decision of the directors is negative, there is a presumption that the disbursement is not warranted.

Any attempt to state the attitude of the courts generally on this point obviously would be imprudent without first having made a careful study of the decided cases, both pro and con, covering the subject. A somewhat cursory review indicates that as yet there has been no decided trend in the opinions. There are, however, enough cases upholding the non-cumulative preferred shareholder in his claim to a right in surplus if profits in a given year are earned but not declared, to merit some serious thought on the part of accountants.

As far back as 1908, a New Jersey court held to the view which favors the non-cumulative preferred shareholder. (Bassett v. U. S. Cast Iron Pipe and Foundry Co., 74 N. J. Eq. 666, 670, 70 Atl. 929). Again in 1924, another action against the same corporation served to emphasize this position. (Day v. U. S. Cast Iron Pipe and Foundry Co. 97 N. J. Eq. 389). In this case, one John Day, holding shares of non-cumulative preferred stock, sued to enjoin the payment of a dividend to common shareholders on the grounds that the company had earned profits equal to $6.11 per share to which non-cumulative preferred shareholders were entitled, but which the company had neither declared nor assigned to such stockholders. The court found for Day and held, in effect, that
although directors may withhold profits earned in a given year, dividends to which non-cumulative preferred shareholders are entitled in that year, if not declared, accrue in favor of such shareholders and must be paid before further dividends are declared in favor of junior shareholders. Commenting on this decision, says the Commercial and Financial Chronicle (Vol. 119, October 25, 1924, page 1966), "Under the Chancery Court's decision, cumulative and non-cumulative preferred stocks differ only in that the former are entitled to dividends whether earned or not in any particular year."

In further support of the position taken by the court in Day v. U. S. Cast Iron Pipe and Foundry Co., it is reported by the press, that the Wabash Railway Company has cancelled the 5% dividend on class “B” preferred stock, announced for February 6, 1929, because of a recent decision of the United States Circuit Court of Appeals sustaining the action of certain class “A” preferred shareholders. This action was brought by the owners of class “A” non-cumulative stock, John C. Barclay and the Willoughby Company, who claimed that such shareholders were entitled to dividends in years when profits were earned, before any dividends could be paid to holders of junior issues. The plaintiffs were defeated in the lower court, but the decision was reversed on appeal, and now, it is said, will be carried up by dominant interests which are affected by the decision of the Court of Appeals.

The tendency suggested by the foregoing decisions, namely, to recognize the rights in surplus of non-cumulative preferred shareholders, is worthy of serious consideration by certified public accountants. If the tendency develops into a well settled attitude on the part of the courts, it will be important that accountants recognize this attitude in their treatment of surplus. The advocacy of a step as revolutionary as segregating surplus representing earned but undeclared dividends, applicable to holders of non-cumulative preferred shares, would be premature at this time. The accountant may safely do no less, it seems, than call attention to the situation, where it applies, in the comments of his report. He may need to go so far as to append a foot-note to the balance sheet, in which attention is directed to the matter. Certainly it would be wise to do so in a balance sheet of the Wabash Railway Company.

News Items

We are pleased to announce that our firm has been registered as qualified auditors under the Hongkong Companies Ordinances, 1911 and 1925. The Hongkong Act, which is modeled somewhat along the lines of the English Companies Act, requires auditors to be registered before they can act officially for companies registered under that act.

Mr. Frederic A. Tilton, our resident partner in Detroit, has been appointed a member of the Industrial Development Committee of the Detroit Board of Commerce. The personnel of this committee is made up of men prominent in industrial and banking circles. The avowed object of the committee is "To foster, encourage, and aid the development of commerce, trade, and industry within the Detroit Metropolitan Area."

Mr. Padon, of our Tulsa office, recently received the C. P. A. certificate from the State of Missouri.

Mr. O. N. Hutchinson, manager of our Charlotte office, has received the C. P. A. certificate of the State of South Carolina.

Mr. G. W. Price, of our Chicago office, is to be congratulated upon his success in passing the C. P. A. examination of the State of Illinois.
In the hall-way of one of New York's historic buildings, now replaced by a modern sky-scraper, stood a bronze statue. The statue was that of the founder of the company to which the building belonged. The pedestal on which the statue rested bore the inscription, "Honesty and truth guard the defenseless."

The company, when it was organized some seventy years ago, entered upon a new line of business. It has passed through some stormy periods. At one time it was the victim of mismanagement and was the subject of legislative investigation. Today, it stands at the head of companies in its field, with assets valued at figures too big for the average mind to apprehend. The faith of its founder long since has been justified.

There are those who see in accountancy only a humdrum day's work; a means of eking out an existence. There are others who look upon it as a business in which success is measured in terms of "gross" and "net." Still others there are who view accountancy as a profession; who get a sense of satisfaction out of its practice as such, and who believe that service motivated by the desire to make each job a good job, cannot help but bring the reward of increasing practice.

The correct concept of accountancy, if but one there be, may represent a horde of bookkeepers out of jobs. It may be a group of technicians, more or less skilled, pursuing financial gain. Again, it may be an assemblage of artisans who delight to do well and faithfully work of which they may be proud. The chances are that accountancy, in its true light, is a combination of technical skill and business ability, bound together with honesty and fearless adherence to truth.

Perhaps no one man, in the early days of the profession, had the vision to see that accountancy, as early as the year 1929, would have reached a point involving twenty-five thousand practitioners throughout this country. It is doubtful if any of the pioneers imagined a volume of practice reaching, probably, well-nigh $100,000,000.00. Probably it was never anticipated that a time would arrive when accountants would be certifying to balance sheets carrying figures in billions.

But, undoubtedly, those who founded the root-organizations of accountancy in this country saw an image of the growth and development in which that service, guided by honesty and truth, has come to constitute a bulwark on which the great credit operations of the country rest.

To see in the mind's eye still greater things for accountancy does not require
large vision. If the imagination of its founders is to be fulfilled, the traditions of the past will need to be preserved, regardless of how accountancy is defined.

Horseless Carriages—1928

If one may rely on published statistics for the year 1928, the number of cars sold by American dealers during that year was 6,980,000. This, obviously, includes used cars the number of which was 3,760,000, or 53.8%.

Of every nine new cars sold five were entirely financed, and the sixth one was financed, graphically speaking, to a point back of the front wheels midway through the hood. Translated into stern statistics, 58.1% of all new cars were financed. Of the used cars sold 60% were financed.

The amount of money invested in car sales during the year 1928 reached the fabulous total of $4,467,600,000.00—four billion, four hundred sixty-seven million six hundred thousand. To the credit of those who bought cars, be it said that collectively they provided 60% of the purchase price and borrowed but 40% thereof. The amount which they borrowed in connection with the financing was only $1,799,330,000.00.

One may look at the repossessions aspect of the situation with some degree of economic pride. Of 3,222,000 new cars sold only 55,900 had to be repossessed, or 1.73% of the total. The collective loss on these cars repossessed amounted to $3,343,000.00. This loss, compared with the amount of $2,820,720,000.00 involved in the purchase price is almost negligible; .117 of 1%.

The loss per new car repossessed was $59.80, compared with an average for all cars, both new and old, repossessed of $56.00. This loss per car was somewhat higher than that for 1927, when the average was $43.00 per car, but lower than that for 1926, when the loss per car reached $65.00.

Any one who is interested in reading statistics and extracting significances therefrom may pick out a tale of keen competition between two great motor car producers by comparing Ford sales with sales of Chevrolet.

Any one who likes to speculate concerning the future may see from the statistics available that while car sales are somewhat concentrated (67.6% in 1928) in three large interests, the remaining sales (30.8% in 1928) are somewhat thinly spread over nine other interests identified by name, with 1.6% (in 1928) grouped as “all others.”

The sales of the “all other” group have decreased from 3.0% in 1925, showing that 1.4% of the sales have been absorbed by specified interests. This business, obviously, did not go to the dominant interests inasmuch as that group, from 1925 to 1928, lost 4.3% of sales to the nine interests not included in the “all other” group. Whether this wearing down of the “big three” will continue, or the smaller companies will resort to consolidation, remains to be seen. The chances, it seems, are in favor of the latter course.

Speaking of exports in 1928, the number of passenger cars and motor trucks shipped from the United States was 507,110; an increase of 32% in number over the previous year. The value of the export shipments was $354,895,862; an increase of 27.6% in value over the preceding year. Out of these percentages the statistician reads the story—“An increase in the number of lower priced cars.” To prove it, he divides the number of vehicles into the value, with the result that the average price per vehicle for 1928 is $699.00 as compared with $723.00 for the year 1927.

Lest we be judged to our advantage, but erroneously for our erudition and research in the matter of motor-car statistics,
we have pleasure in acknowledging our indebtedness for the basic figures in this article to the magazine entitled, “Automotive Industries.” The issue of February 23, 1929, described as the “1929 Statistical Issue,” is replete with data on the automotive industry. Whether one is statistically minded, or merely seeking information, the number is most interesting and valuable.

Standard Costs

By R. A. Dalrymple

THE subject of standard costs is worthy of earnest consideration. A brief discussion may stimulate further study and investigation in this subject which has gained many adherents.

The basic principles briefly stated are as follows:

(1) Standard costs are those costs which competent engineers and operators can establish prior to performance as normal and proper, giving due consideration to the nature and class of cost factors and plant facilities available.

(2) Cost finding by the means of standards is an application of the standards already established to the actual expenditures, retaining an analysis of variations in complete detail.

(3) Accounting reports based on standard costs make full detail comparisons of the variations from actual and thus establish the trend of the industry.

In considering the application of principle (1) we will divide costs into material, labor, and overhead. A new manufacturing venture or a new sales year and program must be predicated on an assumed market basis for the necessary raw materials. If the market changes are unexpectedly violent, drastic changes in the program or sales price of the product will be necessary.

By the application of principle (2) we propose to continue in use throughout the entire period for which the estimate was made the same standard cost of material per unit as that submitted at the time the project or program was undertaken. Along with this standard cost will be shown the actual expenditures for material. The variation from standard will be a composite of several factors, and this variation will be set up on the books divided into the several amounts due to separate causes. Thus, a variation in material cost may properly reflect increase in market price of raw material, decrease in transportation costs, and increase in quantity consumed due to greater percentage of waste than was included in the standard cost. This variation will be further analyzed so that the individual operator, the class of operations, and the department producing this over-standard waste will be shown.

Each one of these items is important in itself and there is potential danger in netting results that have such diverse causes. Having arranged the records so that there is available analyses of material variation, the accountant now applies principle (3) and shows the trend of all the vital factors affecting the cost of raw material.

When the new project or program is undertaken, the second element of cost, namely, labor must be considered and estimated. In order to do this, each operation necessary to convert the basic raw materials into finished product must be separately examined and the class of labor and type of facilities available for said operation must be also taken into account. A standard labor cost is established for each operation which will be given in the following terms:

(1) Standard number of units estimated manufacturable from basic quantity of raw material or previous process.
(2) Standard number of labor hours estimated for needed production of this operation.

(3) Standard labor rate per hour.

(4) Standard labor cost per unit.

The application of principle (2) would require an analysis of actual expenditure which would be in the same terms. That is, for a given day, pay period, or month, there should be definite records pertaining to each labor operation for production of good units, labor hours expended, labor cost, and actual labor cost per unit.

The labor hours per unit have now become as important as the rate per hour, and the labor cost variation is considered as made up of increase in hours required per unit, and the increase in wage rate per hour.

The labor records should describe variations in the number of good units produced according to the standard quantity of basic raw material or previous operation, so that added material cost arising from inefficient utility of the basic raw material can be placed where the responsibility belongs.

In establishing standard costs for overhead expense per unit of production, recognition is given to various factors which have been responsible for cost results apparently irrational. One disturbing factor has been the varying working hours in the calendar months. The salaried employee is usually paid by the month and other overhead charges are on the same basis. This difficulty is overcome by determining the standard working hours in a year, allowing for Sundays, Saturday half-days, legal holidays, and dividing the total by twelve. The difference between standard hours for any specific month and the actual standard hours of a specific month is the variation due to the calendar.

Another factor which has been very difficult to dispose of satisfactorily is the unutilized capacity of the factory. Let us assume, for example, that the plant facilities are reasonably balanced and that their capacity can be established, and that a given percentage of the capacity can be accepted as a standard production for the available facilities. For the plant as a whole there are many expenditures which must be viewed as fixed and be based on this standard production. In these expenditures we class the salaries of works manager, department superintendents, clerks, watchmen, etc. Local taxes and insurance we include in this group and there are many other items which might also be viewed as fixed and not susceptible to adjustment with respect to fluctuations in the actual production.

If for any reason the standard production is not realized, the proportion of fixed overhead applicable to unutilized standard capacity should be earmarked as a variation due to idle plant, and not allowed to confuse the actual cost of factory operations. With respect to each item or group of items composing that portion of overhead which is deemed to be properly an expenditure fluctuating with the units of production, a standard based either on actual experience or sound engineering estimates can be established and actual expenditures should be compared therewith.

Repairs and maintenance can be estimated for the entire plant and a portion of the total included as a fixed charge necessary to maintain the property whether actively in operation or not and the balance which would be all or nearly all applicable to machinery can be assessed to departments, groups of machines, and to individual machines. From this data a standard machine rate is established and variation from this standard can be analyzed to reflect increase in labor hours and rates, supply quantities, and prices, and a very useful control is possible over an item of continuous expenditure that may easily become out of line with the standard estimated.

Similarly, depreciation may be con-
sidered partly a charge to fixed overhead and partly a charge to the fluctuating overhead. In disposing of machine depreciation on this basis, the useful life of the machine is deemed to be the total machine hours of operation, or the total units of production possible before lack of machine efficiency would require replacement. A machine rate would be composed of three factors, namely, power, repairs and maintenance, and depreciation, of which the depreciation rate would be a constant, but the amount of depreciation charged to costs would fluctuate with production. An additional amount of depreciation to protect the industry from the inevitable loss through obsolescence might well be included with the fixed overhead, after making proper charges to loss through idleness. Thus, depreciation is a constant cost, and the plant assets are conservatively valued.

Standards established for a definite period usually are not changed during that period but new standards should recognize all factors of change which have taken place and correct any faulty estimates previously established.

Adjustment of Inventories

By W. G. LaRue, Kansas City Office

Practically every accountant has at some time or other encountered technical problems in the execution of engagements. The following has to deal with the determination of a method to be used in adjusting physical inventories of work in process, finished parts and finished goods (priced at values as shown by cost department records) to approximate cost. Preliminary to the discussion of the determination of this method, the following facts are set forth:

The client maintains a most complete and comprehensive cost accounting system. The factory burden, which includes interest on investment as one of the elements, is based on predetermined departmental machine hour rates. The overhead absorbed in production costs, based on the predetermined rate, has, over a period of years, been in excess of the actual amount of overhead.

The cost records and the general books are reconciled monthly by crediting the difference between the amount of overhead absorbed in production cost, based on the predetermined rate, and the actual amount of overhead to an account known as current variation or factory profit, which, in turn, is credited to profit and loss. The differential, represented by total of the interest and of the current variation or factory profit, is not applied in the cost records as a reduction of the total cost of the various articles of finished parts and finished goods, owing to their being too numerous and varied in character.

If all the finished parts and finished goods produced were sold, it would not be necessary to make any adjustment as the interest on investment and factory profit would then be entirely earned.

In order to eliminate the factory profit and interest, included as an element of cost, from the inventory valuations, the following method was adopted.

The ratio of the total cost of finished parts and of finished product sold, to the average inventory of work in process, finished parts, and finished goods, was determined. This ratio, when applied to the total of the amount of interest, included in cost, and of factory profit, results in the ascertainment of the amount by which the closing inventory should be reduced, in order to eliminate the interest and over-absorbed burden included therein. A practical illustration of the determination and application of the method as above outlined follows:
Inventory at beginning:

Work in process ................. $55,000.00
Finished parts .................... 65,000.00
Finished goods ................... 70,000.00

$190,000.00

Cost of manufacture:

Finished parts .................... $680,000.00
Finished goods ................... 830,000.00  1,510,000.00

Total ................................ $1,700,000.00

Inventory at end:

Work in process ................... $50,000.00
Finished parts .................... 70,000.00
Finished goods ................... 80,000.00

200,000.00

Cost of finished parts and of
finished product sold ............. $1,500,000.00

Average inventory ................ $195,000.00

Ratio of cost of finished parts and of
finished product sold to average inventory ........ 13%

Credits to profit and loss:

Interest on investment ........... $42,500.00
Factory profit ................... 17,500.00

Total ................................ $60,000.00

Interest on investment and factory profit included in inventories, 13% of $60,000.00, or ................ $7,800.00

Per Books Adjustment Adjusted

Adjustment of inventories:

Work in process ................... $50,000.00 $1,950.00 $48,050.00
Finished parts .................... 70,000.00  2,730.00  67,270.00
Finished goods ................... 80,000.00  3,120.00  76,880.00

Total .................. $200,000.00 $7,800.00 $192,200.00

The method as outlined has been followed for a number of years, with the ratio of adjustment remaining practically constant, proving to some extent that the method as outlined may be considered theoretically sound.

Book Reviews


This reviewer confesses to having tucked away, for the purpose of future study, and never to have studied them, the series of bulletins entitled, “Beneath the Surface of Corporation Profits,” upon which Mr. Sloan’s book is based. This reviewer confesses also to representing himself as a certified public accountant. In reading Mr. Sloan’s book, for the purpose of reviewing it, he pleads guilty to having been annoyed by the premise set forth in chapter 1, paragraph 2, to-wit: “It is about accounting, but is not a book on accounting. It examines the results of accounting: takes up the work of the professional accountant where he himself leaves off, seeks to determine the meaning of what his figures report, so far as possible, and seeks likewise to differentiate between meaning and confusion.”

Obviously, there must be some misunderstanding with respect to the function of the professional accountant if the presumption exists that his work has been finished when he compiles and presents certain financial statements. Year in and year out, for many years, educators have been preaching the doctrine that the professional accountant must interpret as well as exhibit the results of his work. These exhortations have had their effect, and the facts are that there has been a marked increase in the amount and quality of interpretation introduced into the reports of certified public accountants. However, so far as the public is concerned, this condition is not apparent. In the case of corporations, the public sees only the reports made by officers of the corporation, included in which, usually, are the financial statements supported by the approval of certified public accountants. Whatever there may be of interpretation or comment appears to be that of company officials. Mr. Sloan, perhaps, has based the conclusions stated in his premise on the examination of published reports, and is not aware of the voluminous comments which are included in the confidential reports of the accountants to the corporations.

Now, that we have settled our score with the author, we may turn, with friendly interest, to a consideration of his book, which is, indeed, a contribution of value to accountants as well as to investors, corporation officials, and bankers. The book affords what might be termed a bird’s-eye view of financial condition and results of operations of American industries. It
considers the characteristic aspects of financial condition and operations, and attempts to bring out the significance of the results characteristically expressed in group form, according to lines, and in some cases according to companies.

The statistical tables are admirable, and the book in this respect takes its place along with those of Bliss and of Gilman in offering standards which may be used to advantage, for comparative purposes, in passing judgment on the efficiency of single corporations.

Not the least interesting part of the book is the index, which includes the names of all companies listed, so that one is guided easily and quickly to information concerning individual companies.

There are some things in the book which, perhaps, are controversial, but inasmuch as no one person may hope to be right about everything, so differences of opinion stimulate study and discussion, usually with the result of adding knowledge to the supply of those concerned. In this respect the chapter on depreciation and depletion should be especially productive, particularly to those who are responsible for the depreciation policies of corporations. It is not difficult to think of several such officials to whom the book may be recommended, with the hope that a reading will not only convey information, but carry conviction that will be productive of improvement in the future.

To the certified public accountant the book is recommended most enthusiastically, with the assurance that all those who read and study it will have their range of knowledge accordingly increased and be helped materially in their efforts to review and interpret the financial operations and results of their various clients whose form of organization is corporate.


The recent break in the stock market seems not to have caused any great decrease in the number and amount of new issues of securities being placed on the market. Offerings of the numerous investment trusts comprise a considerable part of these new offerings.

The investment trust movement in America is attaining vast dimensions, and just now is being subjected rather generally to the limelight of publicity. It is only natural, therefore, that books and articles should appear on the subject, although American experience with this financial growth is relatively of a short period.

The volume was written primarily from a professional point of view, the author himself being directly connected with an investment trust. It is so written that the general investor may gather information from it, and in addition those in financial circles will find much of direct interest.

Investment trusts existed in various countries before receiving much attention in the United States. Much of the history of investment trusts is contained in that of British organizations. The present book covers British trusts briefly before describing the American growth.

The author broadly defines the investment trust as an organization for the collective investment of the funds of numerous individuals in numerous securities. He classifies them from the standpoint of organization into two main groups termed "statutory" and "contractual." The "statutory" trust, as he terms it, is probably more commonly spoken of as a management trust, and the "contractual" as the fixed trust.

The management of the portfolio, questions of accounting, taxation, promotion, public regulation, and analysis of the trust's holdings are discussed in detail. The use of actual names of existing investment trusts for purposes of illustration lends definiteness and point to his discussion.
The chapter on how to invest in an investment trust will probably appeal particularly to the average investor. The author explains certain analytical tests which may be used as a guide in purchasing investment trust securities and in valuing such securities.

It is perhaps in order to mention that the name investment trust, strictly interpreted, is misleading. The officers, generally, do not occupy a fiduciary position as such, although the element of trusteeship is present to the degree that it is in any business organization. The author notes this in describing the origin of investment trusts.

The book is replete with a number of appendices as follows: a classified directory of American investment trusts, specimen charters and by-laws of statutory trusts, specimen indentures of contractual trusts, specimen reports, tabulation of resources, capitalization, earnings, etc., specimen organization charts, and a bibliography. The information contained therein is of great value for reference and statistical purposes.

In the last chapter of the book, the author considers the place of investment trusts in American finance, their services to investors, social considerations, economic significance, and their effect upon security markets.

Additions to the Library


Davis, Herbert L. *Legal Accounting and Court Auditing.* (Kansas City, Vernon Law Book Company, 1928. 796 p.)


Lowrie, Josephine A. *Analysis of Revenues and Expenses of Ohio Daily Newspapers, Year 1925.* (Columbus, Ohio State University Press, June, 1928. 48 p.)


News Items

Mr. O'Connell recently was elected treasurer and appointed chairman of the Finance Committee of the Midland Valley Country Club.

Mr. O. N. Hutchinson, manager of our Charlotte office, has been elected president of the Charlotte Accountants' Club.

Messrs. Robert T. Taylor, E. Stanley Frost, and James E. Armstrong, Jr., of our Baltimore office, are to be congratulated upon passing the November C. P. A. examination of the State of Maryland.
The Money Tangle

"PLAYING the market," using the term loosely, seems to have become the favorite indoor sport. On trains, in waiting-rooms, hotel lobbies, drawing-rooms, between the acts, and in various and sundry other places one hears the chatter about "stocks." Runners for brokerage houses recount their gains and losses. Manicurists are on the lookout for tips. Society matrons wonder if "Hash, common" is a good buy for a rise. In short, the whole country, more or less, is obsessed with the idea of making money in the market.

Securities, in relation to the market, are commodities, like iron and steel. An exchange affords a place where sellers and buyers may meet and have their dealings. The price of securities is determined by effective supply and demand. When demand exceeds supply, prices rise. When supply overrides demand, prices fall. Demand is controlled by the purchasing power of buyers. When money is easily obtainable, demand increases and prices rise. When the supply of money declines, interest rates increase, demand for securities falls off; and unless the supply keeps pace, the prices of securities drop. Thus, the economist explains market prices.

Adam Smith, when he enunciated his principles of economics probably never dreamed of a stock market situation such as exists in this country today. He was not aware of the effect which might be brought about by hundreds of huge investing companies, taking out of and putting into the market, millions of dollars worth of securities. He could not foresee a market-crazed nation, nor a condition of industrial prosperity which would enable corporations to loan on call a volume of surplus funds sufficient to jeopardize the position of the Federal Reserve Board in its control of money matters.

But the chances are that the simple principles which comprise our economic theory will govern in the present somewhat disturbed situation. History will repeat itself, perhaps through slightly different manifestations. When industry needs the surplus funds it has loaned to those who wish to speculate in securities, industry will recall those funds. If funds are not forthcoming from other sources, money rates will rise. When it is no longer profitable to borrow money for speculation, there will be a decline in speculation.

The wisdom required to apprehend all angles and ramifications of the present money tangle is vouchsafed to few. The best one can do is to fall back on principles which have governed such matters since the dawn of civilization. Left to natural laws, probably the situation will right itself.
MOST senior accountants are excellent instructors, willing and able to assist younger men just entering the field of public accounting in mastering the science and art of making audits, preparing working papers, and writing reports. Unfortunately, however, few seniors have much time to devote directly to the instruction and training of their assistants. The demands upon their time are becoming increasingly great, and assistants are desired and needed who can proceed with the work assigned to them without waiting for detailed instructions.

It frequently happens that an inexperienced junior accountant, assigned to the examination of a certain account, does not have a clear conception of the facts he should seek to ascertain. In the following, an attempt will be made to outline, in a very general way, the essential facts which should be developed in connection with the audit of asset accounts.

The auditor should always maintain an alert and inquiring frame of mind. In the examination of an account representing an asset, he should seek to ascertain all of the facts that he himself would desire to know if the asset were his own, or he were contemplating its purchase.

It should be remembered that working papers have a dual purpose: first, to provide a written record of the history and details of the account examined, and to indicate how and to what extent verification was made; and second, to furnish the data from which a concise, clear and interesting report may be readily prepared.

It is often very difficult to secure the necessary facts in connection with a given account; but it should seldom be difficult to determine just what facts are essential to the purpose of the audit. Under almost any circumstances, it would seem that answers obtained to the interrogatives "what," "why," "how," "when," and "where" ought to meet the situation. Perhaps the mental query, "What do we want to know about this account?" can be answered as follows:

1. What is the nature of the asset? Of what does it consist?
2. Does the asset exist at the date of the audit, or has it been consumed, abandoned, or otherwise disposed of? In the case of a receivable, is it collectible?
3. Is title vested in the client? Is the asset subject to any liens or debts?
4. When was the asset acquired, and for what purpose?
5. On what basis of value is the asset stated? What elements enter into the stated value?
6. In the case of a receivable, is it secured, and if so, in what manner?
7. Have any valuation reserves been provided? If so, upon what basis, in what manner, and at what rates are they computed? If not, should reserves be created?
8. How was the asset verified?

It will be noted that the question, "How was it verified?" is given last in the above list. Many auditors approach an audit engagement with the thought of verification foremost in mind; the writer holds to the theory that satisfactory verification is not possible until the auditor has obtained a very clear conception of the nature and history of the thing to be verified.

There is no intent to convey the thought that an audit can be made by applying the above questions, and in the order given, to each and every asset account examined; nor is there an intent to imply that no questions other than the above ever need be applied. No time or effort should be expended by an auditor in attempting to ascertain facts which are apparent from the designation and nature of the account itself; but it is of great importance that no time or effort should be spared to
ascertain important facts which cannot be learned from a casual scrutiny of the records, and which are of prime importance to the purpose of the audit, although possibly of a kind not ordinarily included in an audit program.

Let us see how the questions enumerated above would apply to the audit of accounts receivable.

In the books of a client for whom we are making a general audit, we find the accounts receivable controlling account to have a debit balance of $560,000.00. We find the accounts receivable ledger to be in agreement therewith, as follows:

Debit balances $582,000.00
Credit balances 22,000.00

Balance $560,000.00

Now, let us apply the questions enumerated in the foregoing:

(1) What is the nature of the asset? Of what does it consist?
Upon analysis of the accounts in the accounts receivable ledger, we find the following:

**Debits**
- Due from customers $550,000.00
- Advances to customers acting as sales agents 10,000.00
- Consignments, at selling prices 15,000.00
- Due from manager, loan 2,000.00
- Advances to employees for expenses 3,000.00
- Loans to employees 2,000.00

Total debits $582,000.00

**Credits**
- Due customers on account of overpayments, goods returned, etc. $2,500.00
- Advances from sales for future delivery 7,500.00
- Collections received on shipments made but not yet billed 10,000.00

Due to president (excess of salary over charges to his account) 2,000.00

Total credits 22,000.00

(2) Does the asset exist at the date of the audit, or has it been consumed, abandoned, or otherwise disposed of? Is it collectible?
This question requires that we examine the individual accounts closely, and review them with the credit manager and perhaps with the manager, as a result of which we find:

Customers debit balances aggregating $2,000.00 are known to be uncollectible and should be written off.

A former customer who was acting as sales agent is bankrupt, and final dividend has been received from the trustee; an advance of $1,000.00 made to him remains uncollected and should be written off.

Goods costing $200.00 have been consigned to an individual who misappropriated the merchandise and who cannot be located. His account, being for the above merchandise at selling prices, is $300.00, and should be written off.

Amounts charged to employees for expense advances should be reduced by $1,200.00, to cover expense items which had been paid by the employees, but not taken up in the accounts at the audit date.

The company is carrying balances to the credit of various former customers whose accounts have long been inactive, and who appear to be out of business. These balances aggregate $100.00, and should be taken up in profit and loss.

Shipments of merchandise aggregating $14,000.00 were made prior to the audit date, but the billing therefor has not been recorded in the books. Collections applicable to such sales have been made aggregating $10,000.00; an adjusting entry should be made to take up these unrecorded sales.

In the opinion of the credit manager, accounts due from customers aggregating
$36,000.00 are of doubtful collectibility. In addition, we note that one customer has an account of $2,000.00 which is over one year old; and that the same customer has given a note of $1,500.00 covering a previous balance, and that the note is still uncollected. The credit manager claims that the account and the note will be collected in full, but the manager does not share his view. We conclude that the reserve for uncollectible accounts and notes should be large enough to cover all of the above amounts.

After obtaining the above information, we see that certain items carried in the receivable controlling account do not exist, as assets or liabilities, at the date of the audit; and, of course, all of the accounts which we now consider to be assets will not be collectible; hence, proper provision must be made in the form of a reserve for uncollectible accounts.

(3) Is title vested in the client? Is the asset subject to any liens or debts?
Investigation brings the following to light:
Accounts of customers aggregating $400,000.00 have been assigned to a finance company to secure loans received aggregating $300,000.00.
The company has collected, and has retained, $5,000.00 from accounts assigned; this amount should have been paid to the finance company to apply on the loan.
(4) When was the asset acquired, and for what purpose?
The latter portion of this question has already been answered reasonably well through our analysis under question 1. The query, "When was the asset acquired?" is pertinent, however, and we proceed to age the accounts due from customers. It will not be necessary for us to classify the miscellaneous debit balances according to age, as such a classification would serve no particular purpose. Our object is to determine, in a general way, the status of the client's collections from its customers.

The results of this investigation prove to be as follows:

<table>
<thead>
<tr>
<th>Age of Accounts Receivable</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>$375,000.00</td>
</tr>
<tr>
<td>30 to 60 days</td>
<td>65,000.00</td>
</tr>
<tr>
<td>60 to 90 days</td>
<td>65,000.00</td>
</tr>
<tr>
<td>90 days to 6 months</td>
<td>10,000.00</td>
</tr>
<tr>
<td>6 months to 1 year</td>
<td>15,000.00</td>
</tr>
<tr>
<td>Over 1 year</td>
<td>20,000.00</td>
</tr>
<tr>
<td>Total</td>
<td>$550,000.00</td>
</tr>
</tbody>
</table>

The age of the other items included in accounts receivable as shown by the books should be scrutinized, but is of secondary importance.

(5) On what basis of value is the asset stated? What elements enter into the stated value?
Our analysis of the accounts receivable disclosed that consignments, aggregating $15,000.00 at selling prices, were included. Obviously, the inclusion of consigned goods at sales prices would result in the anticipation of profits; hence we investigate, and find that the cost of the goods consigned was approximately $10,000.00; and we note an adjustment to be made accordingly. We might add, in passing, that when the balance sheet is prepared, goods on consignment will be shown as such, and not as a part of the accounts receivable.

(6) In the case of a receivable, is it secured, and if so, in what manner?
Investigation of this phase reveals that accounts due from customers aggregating $12,000.00 are secured by the deposit of notes and trade acceptances, which appear to be collectible, aggregating $15,000.00; and that the company holds as collateral to an advance of $4,000.00 to an agent, a chattel mortgage covering the merchandise stock, and the fixtures of such agent.
We also find that the company is holding as collateral to the loan to its manager, capital stock of the client company with a par value of $1,500.00.
The above collateral should of course be inspected, and fully described in the working papers.
(7) Have any valuation reserves been provided? If so, upon what basis, in what manner, and at what rates are they computed? If not, should reserves be created?

We find that the company makes a practice of charging profit and loss and crediting reserve for bad debts, for 1% of gross sales. All accounts written off are charged to this reserve. At the audit date, the balance of the reserve account is $20,000.00. We have previously determined that various accounts now on the books should be written off, and that provision should be made for further collection losses of approximately $40,000.00. By review of the charges to profit and loss for this and prior periods, we determine that 1% of sales is not a sufficient allowance for uncollectible accounts, and we therefore note in our papers a recommendation that the client increase its provision in the future to an amount equal to 1¼% of gross sales.

(8) How was the asset verified?

This being a general audit, charges to customers' accounts will probably be verified by tests—i.e., we will trace certain of the charges to the sales and shipping records; credits to customers for cash received, goods returned, and discounts allowed, will likewise be tested. We may request customers to give us written confirmations of their balances. If that is done, the working papers should contain a record of the number of confirmations received, and of the aggregate amount confirmed, and of differences and disputed amounts. Any differences, or amounts in dispute should be subjected to further investigation. Perhaps we will find that various adjustments should be made.

We will secure confirmations of balances from customers acting as sales agents who have received advances, and from those to whom merchandise has been sent on consignment.

Advances to employees will be reviewed with the manager, and perhaps confirmations will be obtained from the employees concerned, unless signed receipts are on file.

Many other steps may be taken in connection with the verification of the accounts, the procedure being dependent upon conditions and the plans of the accountant in charge of the engagement.

We have now ascertained all of the important facts in connection with the account which appears in the books of our client as "Accounts Receivable—$560,000.00." In practice, it is unlikely that the investigation would have been carried on step by step as outlined above; all or part of the various phases of the investigation would have been made concurrently. The working papers would not usually contain separate schedules dealing with the various questions raised; instead, a general schedule for accounts receivable would have been prepared, and, by the use of columnar sheets the various items of information would have been assembled on the one schedule. At the conclusion of our investigation, however, we should prepare a summary showing in concise form the results of the audit. This summary would deal only with totals, and would set forth, in classified form, all of the data obtained from the analysis of the accounts as shown by the client's books, necessary adjustments, and the figures as adjusted for use in our report. The summary should also contain very complete notations showing with whom the accounts were reviewed as to collectibility, the opinion of such person, and the opinion of the accountant making the review; amount of accounts secured, and nature of security; aggregate amount of accounts confirmed, and percentage of the total number of accounts confirmed; explanation of suggested adjustments; and details of method and extent of verification of the various items in the summary.

The above is intended to illustrate how the junior accountant should seize upon the essential points in connection with the audit of an asset account. To anyone
with a limited knowledge of accounting and auditing, the procedure which should be followed might appear very difficult; but as stated before, it should not be difficult to determine just what facts are desired.

Internal Audit Control in a Moderate Sized Business*

By A. F. WAGNER, Manager, Minneapolis Office

(Presented before the Twin Cities Chapter of the National Association of Cost Accountants)

It is impossible to achieve the ideal of internal audit control in the office of a moderate sized business. The principles which should be followed in order to improve internal control in the small office are, in general, as follows:

1. No one person should have all financial matters within his grasp, much less within his control.
2. The controlling records should be divorced from the person who handles funds.

In the small office which has one employee who combines the function of cashier and bookkeeper, all kinds of shortages are possible. These include the abstraction of cash on hand without entry in the records; interception of incoming funds; lapping; that is, applying the collection from one customer to the credit of another customer whose remittance was intercepted; and improper withdrawal of funds, which withdrawals are erroneously entered in the records. The remedies which may be applied in a moderate sized office are as follows:

1. Divorce the functions of cashier and bookkeeper so that it will be difficult for the cashier to manipulate the control records.
2. Use an imprest fund for currency disbursements and have this fund reimbursed periodically for the exact amount of the currency disbursements.
3. Have someone in the office, such as a mail-opening clerk, list the incoming receipts and turn the list over to the bookkeeper as a control on the cashier.
4. Arrange for regular intermittent reconciliations of the bank account by someone other than the cashier.
5. Do not let the cashier make any postings from the cash book.
6. Do not operate the cash account as a mixed cash account; that is, do not have one account which includes both the cash on hand and cash in bank.
7. Insist that each day's cash receipts be deposited in the bank in total in exactly the same form in which they are received. This means that the cashier should not be permitted to cash checks from incoming currency or make disbursements from currency received.
8. Arrange the office routine so that the cashier will not pass on the question of cash discounts or allowances.
9. Do not permit the cashier to draw checks payable to cash, or to sign checks without a counter signature.
10. If checks are spoiled or cancelled, tear off the signature, or space for signature, but do not destroy such spoiled or cancelled checks.
11. If the company has two or more bank accounts, do not permit a choice of two persons to sign checks if both are available. One purpose of this is to prevent a dishonest cashier from obtaining the signature of one official, apparently for the purpose of transferring funds, and then obtain the signature of another person on another check for the purpose of transferring funds, which second check might be used to conceal the improper use of the first check.

It is probably impossible to make use of all of the foregoing in a small office, but the accounting system and delegation of duties should comprehend as many of the foregoing as possible. After a system of in-

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*Reprint from the March 15, 1929, issue of the National Association of Cost Accountants Bulletin.
ternal control is once in use, the officials of the company should from time to time review its operation to ascertain that the system is being followed out according to its intent. In other words, constant vigilance is a great aid in preventing shortages.

There is a twofold purpose in reducing the possibilities of shortages. The first of these is one of momentary saving, because the proof of a shortage, even though the shortage be covered by a fidelity bond, is usually more expensive than the use of the means necessary to prevent the occurrence of a shortage. The other purpose of adopting internal control is to fulfill a moral obligation of employers to their employees by not subjecting employees to undue temptation.

Our Uptown Practice Office

The firm announces that on April 13 the uptown practice office was removed from 37 West 39th Street to the New York Central Building at 75 East 45th Street, and is now known as the New York 45th Street office.

The New York Central Building, rising to a height of thirty-five stories, is located in the heart of the Grand Central Zone. It spans Park Avenue and occupies the entire block between 45th and 46th Streets from Vanderbilt Avenue to Depew Place. Northbound and southbound traffic on Park Avenue passes directly through the building in ramps that rise from the street level at 46th Street and around the Grand Central Terminal on viaducts high enough to permit crosstown traffic on 42nd Street and 45th Street to pass underneath. Its accessibility to both the business and residential sections of the city and its proximity to railroads and rapid transit lines make it a very desirable location.

Our office occupies the southeast corner of the 12th floor, with a floor space that admits of ample accommodations in the way of private offices, a large corner room for managers and supervisors, a large room with three smaller rooms for the use of the staff, a conference room, rooms for the office force, files, etc.

New York C. P. A. Law

On April 9, 1929, Governor Roosevelt signed the new C. P. A. act governing the practice of accountancy in the State of New York. The text of the new law, having appeared in a number of other publications, is not reproduced here.

The substantial changes in the law affect preliminary education, citizenship, certificates by indorsement, and the qualification of co-partnerships. The gist of these sections follows:

After January 1, 1938, every candidate will be obliged to present evidence of having satisfactorily completed the course of study in a college or school of accountancy registered by the Department of Education of the state.

Holders of certificates who are not citizens will be required to complete their citizenship within eight years from the date of declaring their intention; otherwise, the certificates will become void.

In the discretion of the Department, upon recommendation of the Board and subject to the required academic and professional qualifications, holders of certificates issued by other states may have their certificates indorsed, such indorsement making the certificates equivalent to those issued by the State of New York.

Co-partnerships registered by the Department may use the words “certified public accountants,” provided each partner residing or engaged within the state is a certified public accountant of New York and any other partners resident or engaged within the United States are certified public accountants of one or more states. Thus, it appears that a certified public accountant of a state other than New York may be a member of a New York firm, and by indorsement of his certificate, may qualify to practice within the state as a member of a New York firm.
The new law seems to be regarded, generally, as considerable of an improvement over the law which has been in force for many years. Various attempts during the past few years to change the statute have met with failure, and if in the present statute there are points which are not entirely satisfactory, the act as a whole gives promise of affording a better basis for practice than that existing in the past.

News Items

Mr. Forbes was here recently on his usual spring visit to the Executive Offices, returning to San Francisco on April 15.

Mr. Rossetter has been appointed an alternate delegate by The Chicago Association of Commerce to the Seventeenth Annual Meeting of the Chamber of Commerce of the United States to be held in Washington, D. C., from April 29 to May 3, inclusive, and is planning to attend the meeting.

Mr. Rossetter also has been appointed a member of the Finance Committee of the Union League Club of Chicago for the ensuing year, and is a member of the Nominating Committee.

Mr. George P. Auld, of our New York Broad Street office, has an article appearing in the Atlantic Monthly for May on the subject of "Reparations." In this article Mr. Auld makes clear something which long has been difficult for the average reader to understand, namely, the relation of the present Young Committee to the Dawes Committee and of that Committee to the Reparation Committee which preceded it. There are in the article some exceedingly interesting comments on the subject of the debt settlement, the effects of which are bound to be far-reaching, however the problem may be solved.

Mr. William Holding, of the London office, recently spent several weeks in New York on a visit to the Executive Offices. As Mr. Holding has been with the organization for over twenty-five years, he has many friends here, and much of his time was spent in visiting with old acquaintances, both in and out of the office.

Mr. H. S. DeVault, who had been connected with the organization since 1910, resigned in March to accept a position as manager of the New York Credit Men's Adjustment Bureau, Inc.

Mr. DeVault was at one time associate manager of our Atlanta office and later manager of our Shanghai office. Lately he was connected with the New York 39th Street office.

We wish him success in his new work, for which his wide experience admirably suits him.

Mr. G. M. Hayward, of the New York Broad Street office, is to be congratulated on successfully passing the C. P. A. examination of the State of New York.

Mr. T. M. Griffin, of the New York 45th Street office, also is to be congratulated on passing the C. P. A. examination of the State of New York.

Mr. P. L. Bardin, of the Atlanta office, we are glad to announce, has passed the C. P. A. examination of the State of Georgia.

Mr. Fletcher Barker, of the Los Angeles office, we are pleased to announce, has received the C. P. A. certificate of the State of California.

Mr. Don Edwin, also of the Los Angeles office, is to be congratulated upon passing the C. P. A. examination of the State of California.

The name of the building in Seattle in which our office is located—L. C. Smith Building—has been changed to Smith Tower.
With this number the Bulletin will go on vacation, as it were, until October 1. Upon resumption next fall there is a possibility that it will be issued on a quarterly rather than a monthly basis. An expression of opinion on this point from the organization and any suggestions concerning the Bulletin will be welcomed.
Speculation and Speculators

The more one thinks about the present financial situation, the more confusing it becomes. Conflicting views are advanced by various parties, some whose reasons are patent; others whose interest is academic. Individual views, considered separately, may appear to have sufficient strength of logic to dominate the course of reasoning. When these views are considered in relation to the whole situation, they may lose much of their force. Such is the plight of "speculation," now so frequently and widely discussed.

Speculation, as used in connection with securities, connotes risk. A speculative investment is one involving risk, but nevertheless one inspired by hope of gain. A speculative investment lacks the assurance of profit. There is no promise of income. In fact, the chances are that there will be no income, at least for some substantial period. The reward, if it comes, will be in the form of increased value. A principal transaction ultimately will be the means by which any profit is extracted.

The aircraft industry is a speculative industry. Investments in securities of aircraft companies are speculative investments. There will be hundreds, perhaps thousands, of companies organized to build aircraft and aircraft equipment. Most of them will fall by the wayside and millions of dollars will be lost. Out of the milling process will emerge a few companies in whose hands will rest the aircraft business of the country.

The radio field offers another analogy. Various and sundry amateurs will be moved to enter the business by hope of fortune. The savings of friends and relatives will be borrowed for the enterprises. Business men, with what they believe to be a genius for organization, will put together companies and attempt to exploit inventions. Crash after crash will resound through the land, interspersed with the wailings of widows and orphans whose inheritances have been swept into oblivion. But finally, radio, television, and what not, will bring some modern wonder of which Bellamy, projecting his imagination a hundred years into the future, never dreamed.

The capital for the companies which will carry on these enterprises will be furnished by investors. They will be speculative investors, whether they know it or not. Advancement in new and unexplored fields depends upon the risk which investors are willing to take. If those who take such risk are speculators, if the development of these enterprises is speculation, industrial progress depends upon speculation, and those who furnish funds for the exploitation of new fields are speculators.
ONE of the advantages of shares without par value is release from the bondage of tradition. Par shares seemed always to impose certain conditions which none but the most intrepid ever dared to question. In fact to question was to attract unfavorable attention and to risk having the world look askance as if to doubt one's saneness.

General acceptance gave sanction to the theory that the amount of value established by the par of shares outstanding determines the amount of capital of an enterprise, and such must be the amount of asset value, regardless of what it may consist. This theory, perforce, had to be maintained, and the representations of necessity had to fit the theory, regardless of inconsistencies. Thus crept into the deferred charges, discount on capital stock. This deceptive asset was born of expediency. It has been referred to, very appropriately, as "an asset by courtesy." To say the least, this is broad-minded tolerance. To admit the facts, one would have to say that "what can't be cured, must be endured."

Discount on capital stock having par value, obviously, was a necessity in cases where stock was marketed through investment bankers. Likewise, it had to find a place among the deferred charges, under one name or another, in order that the stock might be treated as full paid and non-assessable. But the subterfuge failed to alter the facts, which were that less than the par value of the stock came into the enterprise as effective capital.

Two view-points exist with respect to deferred charges. The first, and perhaps the more common, is that they are gotten rid of by charging them off, as it were, sometime in the future. The second is that they are recovered out of future earnings.

The latter view applies with particular appropriateness to discount on capital stock. The charge arises when the stock is sold. It is an expense of obtaining the capital. It is the antithesis of capital. Therefore, as long as it remains on the balance sheet, it represents a minus quantity; a deduction from the capital. The effect of permitting the discount to remain as an asset on the balance sheet is a double over-statement of capital and of assets. Par capital stock sold at a discount never is shown truthfully, until the entire amount of the discount has been recovered out of earnings. The discount becomes an asset only when replaced by something more tangible growing out of the recovery.

One of the outstanding advantages of capital stock without par value is the opportunity afforded to discontinue the nonsensical fiction of discount on capital stock. It must be conceded that the raising of capital is a necessary factor of corporate enterprise. It must be admitted that the most satisfactory way of raising capital today is by means of the machinery set up by investment bankers. Once an investment house has accepted an offering, the raising of the capital is assured. The investment banker has worked out the scheme whereby it is accomplished. Many times he guarantees that the issue will be sold so as to produce a certain amount to the issuing company. In any event, he must be paid for his services. The amount of his compensation is a matter of negotiation, in which competition among investment houses sometimes plays a part. But this is beside the point. The amount paid for obtaining the capital is not important to this discussion.

The real question is whether the fee paid for the purpose of obtaining capital is an expense of capital, so to speak, or an expense of operation. Those who favor the latter claim that the benefits from the use of capital extend over a period of years and, consequently, that expense attendant upon obtaining the capital should be spread over the years corresponding to the benefits.
This theory is difficult of practical application, because no one can say with any assurance how long the capital will endure or over what period the expense should be written off. Moreover, this practice raises a question of equity every time new capital comes into the enterprise, profits are capitalized, a stock dividend is declared, etc. Also, the practice results in a false representation with respect to the capital employed in the enterprise.

Return on capital is computed properly with the effective capital as the base. To compute return on capital which, in fact, has not been contributed, results in a fictitious conclusion. The recognition of discount in connection with capital stock having no par value results in a false statement. The balance sheet represents that more capital is being employed in the enterprise than actually was received.

The only amount of capital which may be shown properly in connection with no par shares is the amount of consideration received for such shares. A payment for the purpose of obtaining capital is anything but capital received into the business. As a matter of historical record, there can be no objection to showing both sides of the transaction in the capital account. But when the capital account is used for statements, the balance in the account, representing the effective capital available to the enterprise, is the amount pertinent to the purpose.

This conclusion has no authority to support it other than common sense. So far as is known there have been no legal decisions on the point. To dispute the conclusion seems to show evidence of a desire to cling to a tradition which was born of bad practice made necessary by the fiction concerning par shares. If shares without par value had no other advantages, here would be one for which to be thankful. Capital resulting from the issuance of shares without par value should be shown in an amount equal to the value of the consideration for which the shares were exchanged.

It has been said, of course, in opposition to the suggestion of deducting expense before taking up the proceeds from sales of no-par capital stock, that the practice leads to abuses. To admit such charge is not to admit that the practice is unsound. Unscrupulous and conniving promoters probably always will exist. They may organize corporations having shares without par value, make excessive charges for selling the stock, and turn into the company but a meager residue of the amount for which the stock was sold. But the fact remains that all the capital which the company would receive for the purpose of beginning business would be the amount turned over by the selling agents. The trouble here is with the agents; not with the principle involved. And it may be said, without fear of contradiction, that, in this hypothetical case, if the stock sold had a par value the company would receive no more effective capital, but the fact would be concealed by the fiction of a deferred charge. To so show the discount in the case of shares without par value, it is claimed, would act as a deterrent to large commissions. With this, accounting is not concerned.

Rationalization of accounting procedure is one of the things which capital stock without par value makes possible. Not the least of the advantages is the fact that the capital account may be so stated as to show the capital of an enterprise in its true light. It is so shown when the amount is the effective capital made available to the enterprise by the sale of shares.

The Insurance Man Speaks

"You asked me for brief information re: 'sound value as known in the New York Standard Fire Insurance Policy.' The meaning of the phrase 'sound value' is 'cash value' as applied to a policy of fire insurance. It is the cash value of the property insured to an owner at the time a fire occurs."
“Because there are many classes of property and many different interests insured, there are of necessity varied phases of what constitutes the actual cash value.

“Often people are under the impression that an amount agreed upon between the Insurance Company or the broker as to the amount of insurance to be carried constitutes the cash value or the sum to be paid by the Insurance Company in case of fire. That is not correct. Some people even overlook the fact that the underlying principle of a fire insurance contract is indemnity.

“It insures the owner against loss by fire. It does not insure against fire nor does it insure the building or the goods.

“The value of the property destroyed, immediately before the fire, is the limit of the assured’s claim.

“The beginning of the policy reads:


“Does insure……….. and legal representatives, to the extent of the actual cash value (ascertained with proper deductions for depreciation) of the property at the time of loss or damage, but not exceeding the amount which it would cost to repair or replace the same with material of like kind and quality within a reasonable time after such loss or damage, without allowance for any increased cost of repair or reconstruction by reason of any ordinance or law regulating construction or repair and without compensation for loss resulting from interruption of business or manufacture.’

“This excludes again, such losses as profits, trade, derangement of business, payment of salaries even though in consequence of the fire, and the effect is to prevent recovery by fire for any sum greater than measured by the actual cash value of the property injured or destroyed. (There is, as you know, use and occupancy fire insurance and profits fire insurance.)

“Without such a limitation clause the policy would not be one of indemnity and we would have to put a specific value on each risk before the issuance of a policy, which would be an expensive procedure.

“Actual cash value in general terms means the sound value of property at the time of fire, or cost to an insured to replace in the same condition as it was immediately preceding the fire.

“To arrive at the actual cash value, the Insurance Company is entitled to any depreciation, however caused, but nothing can be added to the cash value on account of estimated profits, in estimating the amount of loss.

“The basis of indemnity under a fire insurance policy is money value at the time of fire of property destroyed, not the cost of replacement, the insurer being at all times entitled to any depreciation that may exist.

“An insurer always has a right to reinstatement or replacement of damaged or destroyed property, but the privilege is optional with the Company.

“Buildings:

“To determine the actual cash value, the usual procedure is to take into consideration the original cost, add cost of improvements subsequently made and as the provision in the policy specifies, ‘what it would then cost the insured to replace,’ due allowance must be made for increase in cost of material or labor, should any exist.

“The burden of proof in establishing depreciation rests upon the insurer. Appreciation on account of increase of price of material and labor is often greater than the depreciation.

“Depreciation is often on account of age or condition or it may be proper from other causes: ‘however caused’ is the provision of the policy. A building may have been constructed for some particular purpose, but on account of failure of the enterprise, or unsuitable location, or subsequent change of trade centres, it could not be used for the purpose for which it had been erected, and had become, therefore, in a measure useless. The ‘actual cash value,’ in the event of fire, of such a building could not be determined upon an original cost, less depreciation for ordinary wear and tear, and neither could the measure of in-
demnity be based upon an estimate of the cost of replacement or repairing. Then, again, take the case of a dwelling house built in what was once an outlying section of a city. Afterwards streets are cut through and sewers built and other improvements made, making condemnation proceedings necessary, which proceedings have been commenced prior to fire. In such similar cases, the value of the building as it stood on the day of the fire must be predicated upon commercial or intrinsic value, taking into consideration all the circumstances and facts surrounding the case.

"Personal Property:

"If the insured be a manufacturer of straw hats and his plant destroyed by fire just prior to the opening of the straw hat season, he could collect market value of his stock, in my opinion, and not merely cost of raw stock materials and labor. In this case you see, provided I am right, that the policy is not one of indemnity only in every single case.

"To sum up, a policy of fire insurance is a contract of indemnity, and when loss occurs it must be given a construction which under ordinary conditions will achieve the object of both parties in an honest manner, and the agreement is made that cash value is the limit of the insurer's liability and cash value means the money value of the thing insured in its condition at the time of the fire.

"What seems to me to be rather a fit description of this is to quote the old standard phrase 'that the cost of construction of a summer hotel at the north pole would not be the amount collectible under a fire insurance policy, as such cost would not be so called sound value.'"

"Verification of Financial Statements"

THE Federal Reserve Board has approved a document which will be issued presently in pamphlet form under the title, "Verification of Financial Statements."

The document supersedes one called "Approved Methods for the Preparation of Balance Sheet Statements," which contained "General Instructions for a Balance Sheet Audit of a Manufacturing or a Merchandising Concern."

The old document contained much valuable audit procedure which often failed of attention and use because it was overshadowed by glaring major inconsistencies. The expression "balance sheet audit" was an unhappy one, and led to misunderstanding and controversy. The stated scope of such procedure limited the work of verification to the assets and liabilities. The instructions relating to the profit and loss accounts provided for little more than the preparation of a profit and loss statement, without verification. There was no authoritative source from which one could discover what was meant by "an examination of the essential features of the accounting." In spite of the fact that the profit and loss accounts were not required to be verified the auditor who signed the form of certificate suggested was asked to say that he had audited the accounts for a "period."

The new document eliminates some of the inconsistencies, makes clearer than formerly what is intended, and leaves no doubt about certain things. The scope of the work indicated in the present instructions covers, "a verification of the assets and liabilities of a business enterprise at a given date, a verification of the profit and loss account for the period under review, and, incidentally, an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal check."

It is of the essence in this type of audit, for, with verification as its basis, such it must be called, that the "extent of the verification will be determined by the conditions in each concern. In some cases the auditor may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In
others, where the system of internal check is good, tests only may suffice."

Attention is drawn particularly to the fact that, "In order to certify the profit and loss statement for a given period the auditor must make such verification of the transactions during the period as will justify him in doing so."

The certificate still is in the form to cover a period, but it is consistent now with the program which includes the verification of transactions as well as balances.

There are certain minor changes in the text; perhaps improvements. In the main, however, the improvement consists in making clear the fact that verification is the key-note of the program; that the verification is to be applied to transactions during a period as well as balances at the end of the period; that the extent of the verification in its application to either transactions or balances is dependent upon the effectiveness of the system of internal control; and that, in order to certify to the results of operations, the auditor must verify the operating transactions to the extent which he deems necessary under the circumstances.

A further advantage of the new document is that it makes no mention of the term "balance sheet audit." Inasmuch as the former document was the one which gave the term official sanction, it may be inferred, from its absence in the present case, that the term has been discarded. For this, accountants may be devoutly thankful. The term has been the cause of more distress probably than any other term in auditing usage. Its consignment to limbo should win applause.

Just what name will be given by the profession to the type of service which the new document refers to as "Verification of Financial Statements" remains to be seen. In general structure and outline the procedure conforms to what we term a general audit. Verification typifies it as an audit. The auditing must be applied to operations and transactions as well as results and balances. The character of the auditing always is the same. The extent of its application depends upon the circumstances in each particular case.

Miss Somers' Anniversary

THE firm having achieved an anniversary, its twenty-fifth, a few years ago, we find anniversaries of individual members in the organization occurring with increasing frequency. And so, on May 10, the busy Financial Department of the Executive Offices forgot for awhile there were such perplexing things in the world as trial balances and assumed an air of festivity.

The occasion was the twentieth anniversary of Miss Emma Somers' connection with the organization. For a moment her usual poise and dignity deserted her, but she quickly recovered her composure as she smilingly received the congratulations and good wishes showered upon her by friends and associates, amidst a profusion of beautiful flowers which covered her desk.

A period of two decades spent in struggling with and mastering tiny figures in huge ledgers has left Miss Somers with a cheerful, unruffled disposition, ready always to render help where needed. Her supervision has been one of fairness and justice to all coming under her direction. Virtues such as punctuality and regular attendance have been both her duty and her pride. To the question, "What are among Miss Somers' most striking characteristics?" the answer unhesitatingly is: "Conscientiousness, faithfulness, loyal devotion to the firm she has served so long."

Mingled with our congratulations and good wishes is the hope that the future holds for Miss Somers years of continued efficient service, marked with the same keen interest and enthusiasm which she has always shown in her work.

Book Review

This book affords new material in a field which thus far has not been given much attention by writers on accounting subjects. Mechanical installations, however, have made possible greater strides toward good accounting during the past few years than perhaps any other one factor. The future will probably see a much greater interest in this subject and a much wider application of machine methods. Large industrial combines will need more, rather than less, accounting data, in order to safely administer scattered units of production and merchandising. Economic pressure will insist that this data be supplied at a minimum cost. The opportunity, therefore, will be given to the accountant of dealing with periodic results that are subject to fuller and more complete analyses than otherwise would be readily available. The whole subject is intensely interesting and one having great potentialities. No forward-looking accountant can afford to ignore it.

Messrs. Schnackel and Lang show a thorough acquaintance with their subject and have brought together the necessary facts “to assist accountants in the proper and effective application of mechanical accounting devices to accounting conditions.” As a basis of further discussion there is given a brief description of the mechanical equipment itself including the specific utility of certain distinctive features. The authors are to be commended for their thoroughgoing treatment of the necessity of analytical research work as a preliminary operation in designing forms which are to be set up on the available mechanical equipment. A comprehensive survey of the purposes, description, manner of preparation, and utility of said forms is outlined and should have careful consideration by the reader.

The whole subject of accounting by machine methods has been given careful consideration. Seven chapters deal with the accounting of merchandising operations from order writing and billing systems, handling receivables, instalment accounting, and sales analyses to sales commissions. There is a chapter on accounts payable which includes a discussion of voucher system work. The following three chapters treat of manufacturing accounting and present methods of stock and material control and payroll distribution. The subject of general ledger control is discussed and a chapter is given to the matter of statistical and miscellaneous applications.

The concluding chapter deals with the possible economy and increased efficiency to be realized by affording accounting machine operators specific wage incentive.

The book constitutes a valuable addition to an accountant’s reference and text-book library.

Additions to the Library

*American Year Book; a Record of Events and Progress, Year 1928.* (New York, The American Year Book Company, 1929. 892 p.)

Blum, Louis D. *Blum’s Simplified Method for Ascertaining Profit or Loss on Customers’ Stock Brokerage Accounts.* (New York, Louis D. Blum, 1928. 1 p. 4 forms.)

*Brooklyn Daily Eagle Almanac, 1929.* (Brooklyn, Brooklyn Daily Eagle, 1929.)

Bunnell, Sterling H. *Industrialists: Their Securities and Organization.* (Chicago, A. W. Shaw Company, 1929. 334 p.)


Kirsh, Benjamin S. *Trade Associations; the Legal Aspects.* (New York, Central Book Company, 1928. 271 p.)


Society of Certified Public Accountants of the State of New Jersey. *Year Book, 1928.* (44 p.)


Tolin, Cecil A. *Trust Accounting System Suitable for Beginners for Small Institutions.* (4 p.)


News Items

Effective June 1, 1929, the following are admitted to membership in the firm:
Mr. L. L. Tompkins, manager, Atlanta office; Mr. C. R. Bowen, manager, Cincinnati office; Mr. A. F. Wagner, manager, Minneapolis office; Mr. C. N. Bullock, manager, Detroit office.

We are pleased to announce that Mr. John H. Garrison has been designated as an assistant manager of our New York Broad Street office, effective June 1.

Mr. C. J. Morey, of our New York 45th Street office, gave a talk on "Some Helpful Methods of Accounting and Budget Making for Societies and Associations," at a dinner given by the Conference of Association Executives at Briarcliff Lodge, Briarcliff, New York, on April 12. Informal discussion followed the talk, in which a keen interest in the subject was shown.

Mr. J. R. Hutson, of our Baltimore office, presented a paper on the practical aspects of "Trust Company Audits" before a meeting of the Maryland Association of Certified Public Accountants, held at the Hotel Emerson, on May 14, 1929.

Miss Elizabeth H. Baxter, librarian at the Executive Offices, attended a meeting of the Special Libraries Association held in Washington, D. C., on May 13-15, inclusive.

Miss Baxter is the treasurer of the Association.

Mr. C. A. Zuckschwert, of the Newark office, has been admitted to membership in The Society of Certified Public Accountants of the State of New Jersey.

Mr. J. M. Cashin, of the New York Broad Street office, is to be congratulated upon successfully passing the C. P. A. examination of the State of New York.

We regret to announce the death recently of Mr. Elijah Bates, in Cleveland, Ohio. Mr. Bates was the manager of our Cleveland office from 1919 to 1923, when he resigned to accept the treasurership of The McMyler-Interstate Company, later withdrawing from that company to become associated with R. O. Eastman, Inc.

With this number the *Bulletin* will go on vacation, as it were, until October 1. Upon resumption next fall there is a possibility that it will be issued on a quarterly rather than a monthly basis. An expression of opinion on this point from the organization and any suggestions concerning the *Bulletin* will be welcomed.
Keeping Pace With the Times

The month of September this year has been a month of meetings. What with the meetings of the two national societies, the additional touch of importance given by the International Congress, with the firm meeting coming in the fourth week, September has been a month long to be remembered.

Whether or not meetings are of value, they are a part of the modern system of Babbittry. They are a part of the game; somewhat typically American, perhaps, at least in the way they have been developed of late years.

As an excuse for golf, meetings are perfect institutions. One well-known organization holds its annual gatherings at a resort where the only attraction is a golf course. The members play golf during the day and slumber during the reading of papers in the evening.

But what medium offers greater opportunity for close communion than golf? Where can one get a better insight into the unalloyed character of a friend, or, of an adversary, than on a golf course? Where is there a better test of patience, poise, and perspicacity?

Perhaps the meetings which have just been held, did not contribute an iota to the sum total of knowledge related to accountancy and the dependent subject. Perhaps all the essays that were read were not worth the time consumed in their preparation, and the paper on which they were written. Perhaps the money cost involved in the getting together of such large numbers of persons was wasted. Perhaps the spending of huge sums for entertaining was gross extravagance, and the meetings served but an excuse for a good time.

But granting all of the foregoing, which is far from fact, meetings of the kind, such as have just taken place, would still be justified. Kindred souls have been brought together. Persons interested in the same cause and subjects have had an opportunity to exchange views, face to face. Friendships have been formed; many have been renewed. Outlooks have been broadened. Enthusiasm for the job back home has been quickened. Energy has been stimulated, and “a good time was had by all.”

The habit of annual meetings is a good habit. Various associations find them inspiring and beneficial in the respective strivings. The annual meetings of accountants are a great cohesive factor in knitting the profession into a firmer body, with greater power for good in making the work of the professional accountant an effective instrument in business service.
The annual meeting of Haskins & Sells began at the Executive Offices on Monday, September 23. Colonel Carter presiding, called the partners together at ten o'clock for a short session preceding the general meeting. He announced that Mr. Ludlam, who has been ill for some time, and in the hospital, was now at home and making a rapid recovery. This announcement brought great joy to everyone present. Colonel Carter then reviewed briefly the general results and outstanding events of the previous year and announced the Haskins & Sells Foundation, this institution having been organized during the year for the purpose of rendering assistance to members of the organization who by reason of age or infirmity may be, in the future, prevented from continuing in the organization as actively as in the past.

Following the partners' meeting, the general conference was begun, the morning session being devoted to a general discussion of miscellaneous matters relating to the organization.

Lunch was served in the library at 12:30, following which various informal conferences took place.

The afternoon session of Monday was given over to a discussion of brokerage accounts. Mr. Willins led the discussion and read a paper dealing with the examination of stock brokerage accounts in the preparation of questionnaires which are required by stock exchanges. He pointed out the necessity of having each office as familiar with the examination of stock brokerage houses as our offices in New York City, inasmuch as the increased activity in market affairs is becoming widespread throughout the country and the exchanges of other cities are adopting the practices of the New York Stock Exchange in requiring the questionnaires of member concerns. Mr. Willins also referred to the fact that the New York Stock Exchange has not laid down any definite form in which the information required by the questionnaire is to be furnished. He stated, however, that the form which has been used by New York Broad Street offices for several years has appeared to be satisfactory to the New York Exchange and that he believed if other offices would adopt the same form, the exchanges in the various cities would find it satisfactory. With this thought in mind, the committee which organized the Monday afternoon session, namely, Messrs. Bickett, Willins, and Garrison, had prepared specimen copies of the questionnaire report, with specimen forms used in the examination to accompany mimeographed copies of the remarks on the examination of stock brokerage accounts and the questionnaire. Following Mr. Willins' presentation of the paper there was considerable discussion and many practical questions were asked by representatives of the various practice offices, which showed how timely the subject is.

Monday evening, after group dinner parties, the assemblage attended a theatre party at Chanin's 46th Street theatre (this being a Shubert production), the play being "Follow Through." The appropriateness of this selection was very apparent, from remarks heard here and there during the following days. The play was bright, sparkling, and entertaining, and seems to have been enjoyed by every one present.

The session Tuesday morning was given over to a discussion of the Federal Reserve Bulletin dealing with the verification of financial statements. This subject was presented by Mr. Gause, the session having been organized by a committee consisting of Messrs. Foye, Kracke, and Reik. Following an interesting presentation and discussion, the meeting voted to adopt the Federal Reserve Bulletin as an integral part of our service procedure, the committee having worked out the details of incorporating the procedure into our service classification.
The type of service outlined in the Federal Reserve Bulletin corresponds, in a large measure, to our general audit, the only practical difference being that our general audit is slightly more comprehensive, under certain circumstances, in verifying cash balances and cash transactions. The procedure in the bulletin specifically points out that the procedure therein contained "will not necessarily disclose defalcations nor every understatement of assets concealed in the records of operating transactions or by manipulation of the accounts." It is felt that our own cash procedure, if appropriately and properly applied, should detect understatements of cash concealed in the operating transactions or by manipulations of the records, if applied in accordance with the three situations upon which our cash procedure is predicated. It was agreed that in our general audits we shall follow the Federal Reserve Bulletin, going as much further in the matter of verifying cash balances and cash transactions as may be indicated by the situation in any given case.

After lunch in the library the conference was resumed at 2 P.M., the subject for the afternoon session being investment trusts. This session was organized by a committee consisting of Messrs. Carter, Bickett, Auld, and Wildman. This session evoked, perhaps, more interest than any of the others, as evidenced by the discussion which followed the presentation of the subject. Mr. Auld presented a most interesting paper covering a survey of the subject of so-called investment trusts, the procedure involved in the auditing of such organizations, together with the problems which arise in connection therewith. Mr. Auld pointed out that the predominating type at the present time is difficult of classification, being somewhere between a dealer in securities and a true investment institution. It was also made clear that one of the most important steps in auditing an investment company, or investment trust, is to review carefully the trust indenture, or the management contract under which the trust is operated.

The two chief problems in connection with the auditing of investment trusts were found to be the valuation of stock dividends and the valuation of the portfolio securities. Following the discussion, Colonel Carter announced that the firm policy on these two points would be as follows:

**Stock Dividends:** "A practical solution of this difficult question—one based frankly on a compromise of conflicting arguments and considerations—would seem to be to permit the credit of unrealized stock dividends to income, provided (1) that the item is set out separately in the income statement; (2) that the investment account as a whole is conservatively stated; and (3) that any excess of such credits over the stated value of the stock dividend as charged to earned surplus by the issuing corporation not be used by the receiving corporation for the payment of cash dividends."

**Valuation of Portfolio:** "In this matter, it seems desirable that the firm policy should follow the well-settled principle that appreciation in the value of an asset may not be credited to earned surplus available for distribution in the form of cash dividends. In other words, any increase in the value of the securities in the portfolio due to market appreciation, if taken up on the books, should be credited to some account other than earned surplus and not transferred to earned surplus until such time as the appreciation has been realized."

(In order to understand the full significance of these expressions of firm opinion, it is necessary to consider them together and to realize that a stock dividend has been defined by the New York Stock Exchange as "the capitalization, in whole or in part, of past or current earnings." Obviously then, the dividends have been declared out of earned surplus, but in stock rather than in cash. To the extent that they represent earned surplus, stock dividends may be regarded as income, or as an addition to earned surplus of the recipient.
If the recipient elects to take stock dividends into his accounts at an amount higher than the stated price at which they were transferred from earned surplus to capital by the issuing company, he should credit to unrealized appreciation the excess of market price over stated price. In the last analysis, however, the matter of importance is to insist that cash dividends not be paid out of any excess of market price over stated price; otherwise a qualified report would be inevitable.

The paper on investment trusts will be reproduced in the Haskins & Sells Bulletin; the first installment appears in this number.

One of the interesting features of the Tuesday afternoon session was a talk by our former partner, Mr. Frederic A. Tilton, who is now Third Assistant Post Master General. Mr. Tilton gave a very interesting description of his duties and the many tasks confronting him.

Wednesday was the big day. Several of the more ambitious left early for the Round Hill Country Club, at Greenwich, Connecticut, where those present were guests of Colonel Carter, devoting the morning to warming up and familiarizing themselves with the course.

Lunch was served at 12:30, Mr. Hahn assuming charge of the affair in the self-imposed capacity of Third Assistant Toast Master General. At 1:30, after a delicious lunch, the foursomes began to get underway, and after the smoke of battle had cleared away all were declared to be in about six o'clock.

Mrs. Carter entertained the women of the party at a luncheon at her home, Shamrock Farm, and at seven o'clock all assembled at the Club House for a dinner dance. Supplementing the delicious dinner, the delightful music and entertainment provided, was the announcement of the prizes in connection with the golf tournament. As usual, Mr. Padon carried home a dozen Dunlop golf balls, being the prize for low gross. Mr. Padon's gross score was 90. Colonel Carter won the low net—91—20 = 71 the prize being one dozen U. S. Royal golf balls. Mr. Reik won the high gross, the prize consisting of a box of wooden tees. Out of consideration for Mr. Reik, we refrain from announcing the score.

An added feature of this year's tournament was a kicker's handicap. In order to enter this contest each player had to pay in $3.00. Each contestant then fixed his own handicap by holes. There were three traps, however, of which he was not aware, consisting of a penalty for excessive handicap, a penalty for excessive handicaps on the last two holes, and a penalty for using a ball other than one manufactured by a client. The fees paid in by contestants amounted to $108.00. This total was distributed to the winners as follows: Messrs. Forbes, $32.00; Kracke, $15.00; Carter, $14.00; Coursen, $8.00; Padon, $8.00; Hill, $7.00; O'Connell, $6.00; Bullock, $6.00; Palmer, $6.00; Tilton, $4.00; Porterfield, $2.00. After the distribution of prizes, Mr. Kracke was around inquiring if the collection of so much money would serve to constitute him a professional. The reading of the results and announcement of the prizes by Mr. Foye added considerable mirth to the evening.

Those present at the meeting and social functions were as follows:

Investment Trusts

I—Survey

A recent estimate (New York Evening Post, August 31, 1929) places the number of investment trusts operating in this country at 450, employing a total capital in excess of $2,000,000,000.00. New trusts formed in the first two weeks of September would probably result in revising this figure upward to $2,500,000,000.00 with more to come.

This represents a sensational growth, practically all of it since 1921, when one of the important pioneers, the International Securities Trust of America (predecessor of International Securities Corporation of America) was formed. The industry grew very slowly up to 1924. In the succeeding four years it increased rapidly, up to an estimated capital at January 1, 1929, of $1,000,000,000.00, and since that date it has gone forward by leaps and bounds. Records compiled by the Commercial & Financial Chronicle show that of the new corporate issues brought out in the first seven months of 1929, $1,100,000,000.00 were those of investment trust and holding companies. This constituted about one-sixth of all the new financing done during that period. In July the new issues by investment trusts and holding and trading companies totaled $222,000,000.00 and in August investment trust financing in stock issues alone totaled $341,000,000.00.

It has been estimated that 75% of the total funds of our investment trusts are invested in common and preferred stocks, this proportion representing a considerable increase during the current year owing to the fact that foreign markets have presented less inviting opportunities than heretofore. One survey indicated that about 16% of the total capital was represented by liquid assets. This would indicate that the trusts are carrying at times upward of $300,000,000.00 in cash and loans on call.

By comparison, it is interesting to note that the distribution at July 31, 1929, of an investment fund exceeding $1,000,000,000.00 of one of the great life insurance companies showed about 44% in real estate loans, 15 3/4% in policy loans, 37 1/2% in bonds, 2 1/2% in preferred stocks, 1/2% in common stocks, and 1/4% in cash. The proportion of preferred stocks will undoubtedly increase as it was only recently that a change in the New York laws permitted life insurance companies to invest in preferred stocks and guaranteed common stocks fulfilling certain requirements.

The oldest and best-known group of American investment trusts is that managed by American Founders Corporation. Published reports show that at November 30, 1928, the portfolio of the three principal supervised companies of this group, excluding intercompany holdings, was about $103,000,000.00, of which 58% was in bonds, 5% in preferred stocks, 23% in common stocks, and 14% in cash and call loans. The management has announced that the total resources of this
group in September, 1929, including the management company, exceed $200,000,000.00. Until recently this has been the largest group in the country, but the Goldman Sachs Trading & Financial Corporation, organized in December, 1928, now has a total invested capital of about $244,000,000.00, (see special Investment Trust Supplement of Standard Statistics Company, dated August 12, 1929). Affiliated with the latter are the two more recently organized investment trusts, viz., Shenandoah Corporation and Blue Ridge Corporation. Still more recent organizations are the Prince & Whitely Trading Corporation and the Lehman Corporation, the latter starting operations with a capital of $100,000,000.00.

In Great Britain, where investment trusts originated and where even before the war they constituted an important factor in finance, it has been estimated that in 1928 there were 150 trusts with invested capital of nearly $1,000,000,000.00, (see page 3 of the very valuable book “American Investment Trusts,” by John F Fowler, Vice-President and Secretary of American Trustees Share Corporation, published 1928 by Harper’s). These figures do not include many enterprises which in the United States would be classed as investment trusts.

The term investment trust is something of a misnomer, as most of the institutions covered by the term are not strictly trusts at all. On October 15, 1928, a committee of the Investment Bankers Association of America appointed for the purpose of reporting on the question of State regulation of investment trusts, said, “We are concerned with companies organized to invest and reinvest money and let us therefore represent them at face value and call them investment companies.” Despite the logic of this recommendation, it seems impracticable at this time to get away from the popular term “investment trust.”

The New York Stock Exchange defines Investment Trusts as “such companies as are engaged primarily in the business of investing and reinvesting in the securities of other corporations for the purpose of revenue and for profit, and not in general for the purpose of exercising control.”

Mr. John F. Fowler defines an investment trust broadly as “an organization for the collective investment of the funds of numerous individuals in numerous securities.” He further says: “As defined today, the investment trust has some kinship with holding companies, public utility management companies, savings banks, commercial banks, financing companies, land banks, agricultural credit corporations, building and loan associations, mortgage companies and insurance companies. All these represent a pooling of capital, but they differ from the investment trust in conception. A holding company or public utility management company, like the investment trust, has its assets in the form of securities of other companies, but it differs from the investment trust in that it holds actual or potential managerial control of the companies whose stocks it owns. Especially in the field of public utilities or financial institutions numerous holding companies are in evidence. . . . There is no clear cut dividing line between the holding company or financing company and the investment trust—each may overlap on the province of the other. For general purposes, it may be said that the investment trust purchases securities for the purpose of creating an investment which shall constitute the main source of income, and that such purchases shall be for investment only—not for the acquisition of controlling interests nor primarily for resale. It is argued with good reason that holding company and financing company activities do not mix well with the functions of investment trusts. The main purpose of pure investment may be lost sight of in the managerial view of the companies which control other companies or with the extension of credits to such com-
panies. The true training of investment trust executives does not embrace management of industrial enterprises or the financing thereof."

In a survey conducted in 1928 in an effort (since abandoned) to obtain legislation in New York State for the supervision of investment trusts, Attorney-General Ottinger defined an investment trust (see page 25 of his Supplemental Survey) as "any corporation or association formed under the laws of this or any other State doing business in this State for one or more of the following purposes:

"(1) For the principal purpose, directly or indirectly, of (a) selling, offering for sale, or otherwise marketing its bonds, debentures or other evidences of indebtedness, or shares of stock of the said company, and (b) investing and reinvesting the proceeds thereof in securities.

"(2) For the principal purpose, directly or indirectly, of selling, offering for sale, or otherwise marketing its trust certificates or any certificates of interest of said company or of a trustee, entitling the holder thereof to receive the income from any designated securities or to receive any designated securities or the proceeds thereof deposited with, delivered to or pledged with a trustee for the benefit of any such trust certificate or certificates of indebtedness.

"(3) For the principal purpose, directly or indirectly, of selling, offering for sale, or otherwise marketing its trust certificates or any certificates of interest of said company or of a trustee, and for directly or indirectly investing and reinvesting principal or surplus of any trust fund, the ownership or partial interest in which is evidenced by trust certificates other than stock certificates."

The usual classification of investment trusts by form divides them into two main groups. The first group, called statutory, also called British type or Scottish type, corresponds to the definition appearing under (1) above. The second group called contractual or trust type proper embraces the definitions appearing under (2) and (3) above.

Under the statutory group a new security is created "by setting up the investment trust as an intermediary between the investing public and the securities acquired as an investment." These capital securities, issued in varying proportions of bonds, debentures, and preferred and common stocks, are sold like any other corporate obligation.

The contractual group embraces trusts proper, under which the principle of joint ownership is applied and certificates of participation are issued to the subscribers. "The contractual trust," says Mr. Fowler, "while it usually is formed by a corporation, is itself not a corporation, but a creature of contract. Generally, the contractual trust comes under the legal definition of a common law trust—'a right of property held by one for the benefit of another or others.' The person who holds the right of property—legal title—is the trustee and the beneficiaries are those for whose advantage the trust is created. It is possible for a contractual trust to be so framed as to vest legal (as distinguished from equitable) title to an investment fund in the certificate holders. The organization then created is not a common law trust, but is evidenced merely by a 'deposit agreement.' Thus, the indenture for Diversified Trustee Shares, series 'B' (American Trustees Share Corporation) specifically affirms that '(legal) title to the deposited stocks and securities shall vest in the respective certificate holders in proportion to their holdings of certificates.'"

Under the contractual form an invest-
ment fund is deposited with a trustee and certificates of interest are sold to investors at a price based on the value of the securities in the fund plus a differential representing the cost of raising capital and other expenses, such as trustees' fees paid in connection with the deposit and custodianship of property in the investment fund. These differentials vary from 1% to 10% or more on the value of the principal.

Two general classes of contractual trusts may be recognized, namely the general fund type and the unit share type, the latter sometimes known as "bankers' share," "collateral share," "stock conversion," or "trustees' share." The broad distinction between these two types of contractual trusts is that certificates of the general fund type are issued against a fund (or one of a series of funds) of considerable size, say $1,000,000.00, which has been accumulated according to no rigid scheme and frequently under an indenture permitting substitutions, while the certificates of the unit share trust are issued against one of several or many relatively small (say $20,000.00) identical blocks or units of investment securities, each unit being in itself virtually a small trust, which is in many or most cases of a rigid type not permitting substitutions. The unit trust participations are divided into shares, representing a proportionate ownership, say 1/1000 part, in one of the units.

As an example of the unit share type, each Diversified Trustee Share, series "B," (issued by American Trustee Share Corporation), represents a 1/1000 interest in a unit of 134 shares of specified common stocks comprising 30 shares of seven railroad stocks, 28 shares of seven public utilities stocks and 76 shares of sixteen industrial stocks.

"To be valid the instrument by which a contractual trust is created must not violate the well-known rule against perpetuities or against restraints on alienations. . . . Certificate holders may redeem their certificates for cash or convert them directly into the deposited securities . . . Redemption, in the case of unit share trusts, is usually accomplished through a provision for convertibility of certificates. The holder of shares aggregating a full interest in a unit on surrender of his certificates, received a unit of the deposited securities; no redemption fee is charged." (Fowler.)

(To be Continued)
What Is Surplus?

The capital of a corporation is divided into two parts: that which revolves and that which is fixed. The revolving or working part is supposed to increase as it works. The fixed part has a habit of decreasing, and the decrease has to be absorbed by the increase of the part that works.

Capital is an abstract term. It denotes a certain number of dollars invested in an enterprise. The concrete evidence of capital is found in the form of goods, or property, or representations of money, to which dollar values have been assigned.

If the things which represent working capital increase in amount, through use, their counterpart of necessity must increase. If capital is a standard by which financial condition is to be judged, then any increase in values in excess of the amount contributed as that standard, may be regarded as surplus.

The surplus account was intended originally, no doubt, to show the increase, through use, in the amount of working assets. It was designed to show how much could be extracted from those assets without diminishing the amount originally invested in them.

But necessity, expediency, and the march of progress have made of the account, as originally conceived, a heterogeneous affair, difficult to describe, and meaningless except when subjected to the merciless test of strict analysis. Into it, of late years, have gone amounts representing estimated increases in the value of physical property, market appreciation of highly speculative common stocks held as investments, arbitrary apportionments of contributed capital, adjustments resulting from conversions of capital liabilities, etc., etc.

The prime purpose of a surplus account was to show the amount available for distribution as cash dividends. It has become an account, in many instances, which shows anything but that. The abuse of the surplus account has resulted in a reaction which bids fair to restore the account to its proper meaning and use. The efforts of the American Institute of Accountants to bring about the practice of designating such surplus as "earned surplus" and to differentiate it from all other forms of so-called surplus, are worthy of prolonged applause.

Surplus, without doubt, is the excess of assets over liabilities and capital. But, more and more, fortunately, modern practice is coming to the point of relating the surplus to the assets in which it rests; in differentiating that part which is represented by accretions to current assets, and
therefore is severable and may be divided, from that which is represented by capital assets which have been revalued, for one or another reason.

In the accounting of the future, there will be no such term as "surplus" alone. It will be surplus so qualified as to indicate its derivation.

Investment Trusts
I—Survey
(Continued)

Most American investment trusts are of the statutory or British type; out of 199 investment trusts classified by Mr. Fowler as of July 1, 1928, 146 were statutory type, 21 were contractual—general fund type and 32 were contractual—unit share type. These were further classified according to restrictions on the composition of portfolio and general discretion in its management, as follows:

<table>
<thead>
<tr>
<th>Classification per Fowler</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>General management........</td>
<td>153</td>
</tr>
<tr>
<td>Specialized management....</td>
<td>12</td>
</tr>
<tr>
<td>Fixed or limited management</td>
<td>25</td>
</tr>
<tr>
<td>Holding and financial companies</td>
<td>50</td>
</tr>
<tr>
<td>Total....................</td>
<td>240</td>
</tr>
</tbody>
</table>

The following trusts, all of them of the statutory type, are among those, as listed by Fowler, in which the management has unlimited discretion regarding investment:

- Principal Banking, Underwriting or Fiscal Agent
- Name of Trust
- General American Investors, Inc. Lazard Freres
- Old Colony Investment Trust Old Colony Corporation
- Shawmut Bank & Investment Trust National Shawmut Bank
- Standard Investing Corporation Brown Brothers & Co.

On the other hand, the following trusts, all of which are of the contractual-unit share form, are indicated by Fowler as being of the fixed type in which the sponsors have no discretion to change the contents of the portfolio:

- Principal Banking, Underwriting or Fiscal Agent
- Name of Trust
- American Basic Business Shares Corporation F. J. Lisman & Company
- American Trustees Share Corporation Throckmorton & Co.
- Investment Trust Shares, series “A” and “B” Prudential Company
- Investors’ Trustee Foundation of United States Colyer & McGuire

In between these extremes are certain trusts like the companies of American Founders group in which the by-laws and resolutions of the Board lay down certain requirements as to diversification of portfolio by industry and country and as to investment caliber of securities acquired. As a result of these requirements, the portfolios of three of the group, as shown by published reports at November 30, 1928, were composed as follows:
### DIVERSIFICATION BY TYPES OF SECURITIES, NOVEMBER 30, 1928 (IN THOUSANDS OF DOLLARS)

<table>
<thead>
<tr>
<th>Securities Corporation of America</th>
<th>Second International Securities Corporation</th>
<th>United States &amp; British International Company, Ltd.</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>Amount</td>
<td>%</td>
<td>Amount</td>
</tr>
<tr>
<td>---</td>
<td>--------</td>
<td>---</td>
<td>--------</td>
</tr>
<tr>
<td>Bonds</td>
<td>66.37</td>
<td>$42,686</td>
<td>50.62</td>
</tr>
<tr>
<td>Preferred stocks</td>
<td>3.75</td>
<td>2,410</td>
<td>3.29</td>
</tr>
<tr>
<td>Common stocks</td>
<td>14.19</td>
<td>9,122</td>
<td>37.51</td>
</tr>
<tr>
<td>Cash and call loans</td>
<td>15.69</td>
<td>10,089</td>
<td>8.58</td>
</tr>
<tr>
<td>Total</td>
<td>100.00</td>
<td>$64,307</td>
<td>100.00</td>
</tr>
</tbody>
</table>

### GEOGRAPHICAL DISTRIBUTION, NOVEMBER 30, 1928 (IN THOUSANDS OF DOLLARS)

<table>
<thead>
<tr>
<th>Location</th>
<th>%</th>
<th>Amount</th>
<th>%</th>
<th>Amount</th>
<th>%</th>
<th>Amount</th>
<th>Total</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States of America</td>
<td>15.88</td>
<td>$10,212</td>
<td>14.73</td>
<td>$3,262</td>
<td>14.68</td>
<td>$3,294</td>
<td>16.30</td>
<td>$16,768</td>
</tr>
<tr>
<td>Central and South America</td>
<td>6.29</td>
<td>4,046</td>
<td>2.66</td>
<td>589</td>
<td>3.17</td>
<td>521</td>
<td>5.02</td>
<td>9,116</td>
</tr>
<tr>
<td>Central Europe</td>
<td>37.72</td>
<td>24,257</td>
<td>41.55</td>
<td>9,202</td>
<td>40.32</td>
<td>3,841</td>
<td>36.26</td>
<td>37,300</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>11.14</td>
<td>7,163</td>
<td>5.46</td>
<td>1,209</td>
<td>4.28</td>
<td>947</td>
<td>4.74</td>
<td>10,247</td>
</tr>
<tr>
<td>Western Europe</td>
<td>11.34</td>
<td>7,163</td>
<td>6.46</td>
<td>1,430</td>
<td>6.63</td>
<td>1,088</td>
<td>4.97</td>
<td>10,247</td>
</tr>
<tr>
<td>Japan and other Asiatic Countries</td>
<td>4.04</td>
<td>2,598</td>
<td>6.46</td>
<td>1,430</td>
<td>6.63</td>
<td>1,088</td>
<td>4.97</td>
<td>10,247</td>
</tr>
<tr>
<td>Cash</td>
<td>15.69</td>
<td>10,089</td>
<td>8.58</td>
<td>1,902</td>
<td>12.65</td>
<td>2,075</td>
<td>13.67</td>
<td>14,066</td>
</tr>
<tr>
<td>Total</td>
<td>100.00</td>
<td>$64,307</td>
<td>100.00</td>
<td>$22,147</td>
<td>100.00</td>
<td>$16,405</td>
<td>100.00</td>
<td>$102,859</td>
</tr>
</tbody>
</table>

### DIVERSIFICATION BY TYPES OF INDUSTRY, NOVEMBER 30, 1928 (IN THOUSANDS OF DOLLARS)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>Amount</td>
<td>%</td>
<td>Amount</td>
<td>%</td>
</tr>
<tr>
<td>---</td>
<td>--------</td>
<td>---</td>
<td>--------</td>
<td>---</td>
</tr>
<tr>
<td>Government and Municipal</td>
<td>30.59</td>
<td>$19,672</td>
<td>25.54</td>
<td>$8,656</td>
</tr>
<tr>
<td>Transportation</td>
<td>3.84</td>
<td>2,469</td>
<td>5.46</td>
<td>1,209</td>
</tr>
<tr>
<td>Public Utilities</td>
<td>12.75</td>
<td>8,199</td>
<td>7.71</td>
<td>1,707</td>
</tr>
<tr>
<td>Industrials</td>
<td>18.88</td>
<td>12,142</td>
<td>29.79</td>
<td>6,598</td>
</tr>
<tr>
<td>Mortgage banks, banks and trust companies</td>
<td>13.24</td>
<td>8,514</td>
<td>15.18</td>
<td>3,361</td>
</tr>
<tr>
<td>Investment organizations</td>
<td>4.65</td>
<td>2,990</td>
<td>7.05</td>
<td>1,561</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>3.76</td>
<td>232</td>
<td>6.98</td>
<td>153</td>
</tr>
<tr>
<td>Cash</td>
<td>15.69</td>
<td>10,089</td>
<td>8.58</td>
<td>1,902</td>
</tr>
<tr>
<td>Total</td>
<td>100.00</td>
<td>$64,307</td>
<td>100.00</td>
<td>$22,147</td>
</tr>
</tbody>
</table>

We have Fowler's authority for saying that most discretionary trusts do not specify that their investments shall be marketable. Investment Managers Company, however, goes all the way in assuring that securities in the fund shall have a ready market. Stocks to be purchased must be listed on the New York Stock Exchange and transactions in them must have been recorded within the period of one year; the total outstanding amount of any given stock must be at least $20,000,-
000.00. United States Shares Corporation in its common stock trust shares, series "A-1," provides that each of its securities shall be listed on the New York, Boston or Chicago Stock Exchange. Mutual Investment Company states that not less than 60 per cent. of the investment fund shall be in securities listed on the New York Stock Exchange. International Securities Corporation of America agrees merely that its investments must be "marketable."

Restrictions regarding the investment caliber of securities purchased, are, in the case of common stock trust shares, series "A-1," of United States Shares Corporation, that "no more than 10% shall be in shares rated lower than Ba in Moody's Manual; no stocks shall be acquired if rated lower than B; no more than 50% shall be in stocks rated lower than Baa; not less than 20% must be in stocks rated A or higher." The stocks must also have paid a dividend within six months.

More liberal is the provision of International Securities Corporation of America that securities to be eligible for purchase must be seasoned and the issues must have been established at least four years. North American Investors Corporation stipulates that "only those securities will be purchased about which reliable information and data can be ascertained relative to management, history, assets, earnings, and income of the corporations or other authorities or organizations issuing securities."

Fixed trusts and most management trusts which contemplate the exercise of comparatively little management take the unit share form. The conditions under which substitutions, if any, may be made, are strictly prescribed by the unit share trust in advance. The disposition to be made of stock dividends and subscription rights must be prescribed in fixed trusts and is frequently prescribed in other unit share trusts. Diversified trustee shares, series "B," of American Trustees Share Corporation provide that subscription rights shall be sold and stock dividends other than fractional and odd shares shall be retained in the fund. Bank stock trust shares, series "C-1," "C-2," and "C-3" of United States Shares Corporation provide for retaining all stock dividends. Series "C-1" provides for the sale of rights, series "C-2" for the exercise of rights, and series "C-3" for the exercise or sale of rights at the discretion of managers.

In the case of general management trusts, a separate management corporation frequently administers the portfolio for a fee. A usual basis for such a fee is ½ of 1% annually on the invested capital, which Fowler estimates would be equivalent approximately to 5% of income from the portfolio. This calculation assumes a rate of income from the portfolio (gross income) of 10%, which in Fowler's observation is a fair assumption. This more or less standard fee of ½% per annum on principal is the rate paid to American Founders group by its companies other than International Securities Corporation of America. Some management fees, however, are based on a percentage of income of the portfolio; such fees range from 4% (in the case of International Securities Corporation of America, calculated on gross income including trading profits less taxes) up to 15% or more.

It has been announced that the contract under which the new Lehman Corporation will be managed by the firm of Lehman Brothers establishes an entirely new basis for agreements of this character. The firm is to receive semi-annually for its services 12½% of the net realized profits of the corporation, which compensation the firm agrees to use, upon receipt, for purchase from the corporation of common stock taken at its book value. This compensation will be paid only to the extent that the net realized profits of the semi-annual period then terminated shall exceed a sum equivalent to (1) 6% per annum upon the invested capital (as defined in the agreement) for the period, plus (2) any deficiency in net profits of any prior period below 6% per annum upon the invested
capital. The payment of any balance of compensation will be deferred and added to the compensation payable for succeeding periods. Unrealized profits will not be taken into consideration in determining the above-mentioned compensation or the book value of common stock purchased; but upon the termination of the agreement the firm will receive 12½% of the unrealized profits (subject to certain deductions as set forth in the agreement) and, out of the remainder of such unrealized profits, any balance of compensation the payment of which may have been deferred. The firm may, at its option, apply such final compensation to the purchase of common stock on the basis above-mentioned.

In some cases various supplementary forms of compensation accrue to the managers in the form of stock warrants, etc., and the New York Stock Exchange has taken cognizance of this situation by requiring that all applications for listing must set forth full details of the basis of management compensation in any form, whether direct or indirect. The Exchange also requires that only customary and reasonable commissions shall be charged by the management for the purchase and sale of securities for the trust.

The latest trend in the organization of investment trusts seems to be toward the transformation or partial transformation of banking firms and investment houses into corporations which frankly stress the trading rather than the investment feature. Such institutions, being promoted by, and in some instances carrying the names of houses well known in the street are at present strong market favorites. This appeal to the public lies in the prestige of the names behind them, and as yet little is known as to the composition of their portfolios. Some of the recently organized trusts have acquired considerable blocks of domestic stocks at present levels, though undoubtedly there have also been considerable acquisitions of bonds and of foreign securities, in which prices are at lower levels.

The New York Stock Exchange requires that all holdings shall be listed in detail in an annual report, except that 10% of the capital and surplus or 10% of the cost of securities held, whichever may be less, may be covered under a heading “Miscellaneous Securities,” provided that such securities have not been held for more than a year. This latter fact shall be certified to by a public accountant, who shall also certify the financial statements and inventories. The provision permitting the showing of “Miscellaneous Securities” as a lump sum was included to protect the companies from the necessity of divulging information of value to competitors during the period of accumulation of new holdings. Aggregate cost and market value of the holdings are also to be shown, with the detail of all prices used for valuation of securities not listed on the New York Stock Exchange or the New York Curb Market. Reserves against possible losses shall also be shown.

The capital structure of the trust is a matter of importance to the investor. Normally, in the opinion of Fowler, a conservative ratio would be:

<table>
<thead>
<tr>
<th>Securities</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>50%</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>30%</td>
</tr>
<tr>
<td>Common stock</td>
<td>20%</td>
</tr>
<tr>
<td><strong>Total capital</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

Assuming a capitalization of $100,000.00 with 5% bonds and 6% preferred stock, his calculations show that a trust earning 6% on its portfolio would, on the above structure, earn 8½% on its common stock. A trust, however, whose assets are invested largely in common stocks ought to follow a conservative practice in the issuance of capital securities carrying fixed charges. The Stock Exchange listing requirements provide that no non-voting stocks will be listed unless substantially preferred as to both dividends and assets, and that non-voting stock shall be accorded the right to vote when one year’s preferential dividends are in arrears.

The principal sources of income of investment trusts are, obviously; interest and dividends, and in the case of
statutory trusts, profits on sales of securities. Underwriting profits are also a factor in the income accounts of investment trusts and seem likely to become more important. Some of the older trusts prohibit or restrict the amount of underwriting activity. Profits on sales of securities during the past several years have been large. Such profits are not likely to continue on the same scale. But in companies whose operations are world-wide there seems to be much in the contention that there are always promising markets where good securities may be bought cheap and held for appreciation.

Fowler estimates that American investment trusts have been earning 10% from the portfolio annually, including 6% in interest and dividends and 4% on sale of securities, which latter, assuming a turnover of 50% of the portfolio a year means an average profit on sales of 8%. Doctor Robinson, President of Second International Securities Corporation, estimated in 1925 that an average of 7% might be earned in interest and dividends, and 3% on turnover, or a total of 10% from the portfolio. Calculating the cost of raising capital through sale of common shares at 5%, and deducting 1% for administration expenses, the earnings in his opinion should be equivalent to $8\frac{1}{2}%$ on the capital subscribed. Assuming that an equal amount of capital would be contributed by bondholders at an annual cost of 6\frac{1}{4}%, earnings available for common would be 11%. Some companies have done better than this, particularly in 1927, but we have seen no general compilation of statistics on the subject.

Figures compiled by Doctor Robinson show in the year 1924–1925 for 23 leading English trusts an average investment yield of 6.03% and for 21 Scottish companies an average of 6.30%. These earnings represent interest, dividends, and substantial underwriting fees, less a heavy income tax of 4 shillings in the pound. By borrowing money at 4% and after paying expenses averaging less than ½%, the yield on common averaged for the English companies 10.83% and for the Scottish companies 14.49%. Profits on turnover are not included. Such profits are credited to investment reserves as a measure of conservatism and also for the reason that if so credited no income tax is payable.

The New York Stock Exchange listing requirements provide that the income account “shall include all revenue, as well as all losses, from whatever source derived. It shall reflect in the aggregate a profit and loss upon each and every completed transaction consummated by a purchase and sale of securities. A technical short sale against a long position must not be used for the purpose of considering any transaction as incomplete. . . . The income account shall include no profits resulting from participation in a syndicate, offering securities to the public, until such syndicate is closed. If the applicant enters into any other operations in account with others, the profit or loss at the date of each published financial statement must be reflected therein.”

A further ruling of the Exchange provides that “applicants must agree not to pay any cash or stock dividends on common stock, when such dividends, plus any amount by which the current value of securities held shall be less than their cost, exceed the earned surplus and undivided profits. For the purpose of the foregoing agreement, stock dividends must be capitalized on what appears to the Committee to be a reasonable basis.”

The various rulings of the Stock Exchange referred to above, relating especially to publication of holdings, management fees, and payment of dividends, together with a ruling on the valuation of stock dividends received, which will be discussed below, are an indication of the importance of some of the problems raised by the emergence of investment trusts in this country.

From an accounting standpoint, the two most important questions relate to the valuation of the investments and to the valuation of stock dividends and rights
received. These questions, while not peculiar to investment trusts, arise there with special emphasis, due to the size of their holdings. Most investment trusts—probably with few exceptions—carry their investments at cost. Under Federal income tax regulations, dealers in securities are allowed to compute income on the basis of carrying their “inventories” of securities either at cost or at market (or, as a third alternative, at the lower of cost or market).

So far as we are aware, no investment trust has claimed the status of a dealer in securities. The establishment of such a status for tax purposes might conceivably create a presumption in favor of regarding as income for all purposes unrealized profits arising from valuing the portfolio at market, though we would still question the soundness of such a presumption. However, inasmuch as a dealer in securities is defined by the tax regulations as a “merchant of securities,” who hold them “for purposes of resale and not for investment,” it does not seem probable that an investment trust could qualify as such. Moreover, most investment trusts, having been organized during the appreciating markets of the past several years, have had no occasion to desire to adopt the market basis of valuing their portfolio for any advantage it might have in connection with income tax; and the tax regulations require the continuance of the method first adopted.

Within our observation the adjustment of the investment account to market is not a common practice, even among those clearly to be classed as dealers in securities. Possibly our failure to observe this is because many dealers in securities operate as individuals or partnerships and do not have their accounts audited. In any case, the inclusion of market appreciation in the capital account of an individual or a firm would not raise the same questions as those which would be involved in the case of the surplus account of a corporation. While the availability of unrealized appreciation of assets for the purpose of paying cash dividends is not, in most States, explicitly banned by statute and is in one state (Wisconsin) explicitly permitted by statute, the weight of court decisions and of accounting opinion is against it. Whatever the auditor’s personal views on the economic aspects of the subject, his professional safeguard is to insist that unrealized gains from reappraisals be set out separately from earned surplus. With investment trusts, our practice is to include the investments in the balance sheet at cost (less investment reserve, if any) and to show in brackets the market value at closing date.

The valuation of stock dividends received and its effect on income present a more difficult problem. By the term “stock dividends” it is intended to imply “true stock dividends,” as defined by the New York Stock Exchange, which distinguishes them from stock “split-ups,” in the following terms: “As a matter of definition from the point of view of the Exchange, a true stock dividend represents the capitalization, in whole or in part, of past or current earnings; while a split-up has not of necessity any relation to earnings and may mean nothing more than a change in the form in which ownership in an existing situation is expressed.”

With relation to the receipt of stock dividends, three general practices prevail. One of them follows Federal income tax procedure, under which no income arises on the receipt of a stock dividend unless it is sold. The stock dividend is taken on the books at no value. If other shares of the same issue (or of one of substantially the same character or preference) are carried at a price in investment account, an average cost of the old and new shares results; and if and when the dividend shares are sold only that part of the proceeds which exceeds that average cost is returned as income. If the old shares are not of the same issue as the dividend shares, the tax regulations provide for an allocation of a part of the cost of the old shares to the new shares on the basis of respective market values “at the time the new shares
of stock are distributed,” and the profit on sale of the new shares is computed on the basis of such allocated cost. In cases of the last-named variety one of our large clients who otherwise calculates profits in accordance with the tax regulations, does not allocate the cost between old and new stock, but takes in the entire proceeds of sale as income.

(To be Continued)

Additions to the Library

American Electric Railway Association. *Classification of Accounts for Bus Operating Companies with Annual Operating Revenues more than $100,000, as Adopted by the American Electric Railway Accountants’ Association.* (New York, American Electric Railway Association, 1925. 72 p.)


International Congress on Accounting. *Papers Discussed at the Annual Meeting, New York, September 9-14, 1929*


Maloney, John P. *Corporation Law Notes.* (Brooklyn, The Accountancy Press, c1928.)

Myer, Joseph C. *Standard Accounting Text.* (Brooklyn, Joseph C. Myer, c1928. 2v.)


Polk’s Bankers Encyclopedia (Purple Book). (New York, Bankers Encyclopedia Company, September, 1929.)


The Seaboard National Bank. *New York City Banks and Trust Companies with a record of Charter Dates, Failures, Liquidations, Mergers and Change of Name During the Last Twenty-five Years.* (New York, Seaboard National Bank, 1928. 53 p.)

Strain, Myron M. *Industrial Balance Sheets; A Study in Business Analysis.* (New York, Harper & Brothers, 1929. 182 p.)

News Items

Col. Carter made a several weeks’ tour of the western practice offices during October.

Mr. C. H. Lee, formerly a manager of the Chicago office, has been appointed manager of the Buffalo office, effective October 1.

Mr. J. H. Boyland, of the New York 45th Street office, is to be congratulated upon passing the C. P. A. examination of the State of New York.

Mr. P. K. Webster, of the Los Angeles office, is to be congratulated upon receiving the C. P. A. certificate of the State of California as the result of passing the examination in 1926 and completing the three-years’ experience required.

We are pleased to announce that Mr. J. J. Shrewsbury, of the Los Angeles office, has been granted a California C. P. A. certificate through reciprocity with the State of Colorado.

Mr. H. L. McEwen, manager of the Watertown office, has been elected Treasurer of the Watertown Rotary Club.
Book Versus Market

NOTHING has exemplified more concretely Einstein’s theory of relativity than the recent debacle in the stock market. One might almost say the “common stock market.” While common stocks slid off, bonds moved up, and preferred stocks were slow to show the influence of the general market.

The cause, or causes, are difficult to assign. Over-supply of new securities, in accordance with Mr. Kent’s theory, may have been partially accountable. The manipulations of blind pools may have contributed their effect. A definite campaign of deflation may have been responsible. Or the time for gathering in the “fleece” may have brought about the result.

Whatever the cause, the effect has been an unparalleled decline in market values. Stocks which formerly had high sale and loan values have declined from one to two hundred points. Verily, this is a market so filled with bargains that the small investor is like a child before a resplendent candy case, with a penny to spend.

The decline has brought sharply to the attention the comparison of values as determined by the supply of and demand for certain stocks and the values of those stocks as determined by the books of account of the corporations issuing the stocks. Never before, perhaps, has the disparity between market values and values based on earnings been so apparent.

Statistics for the first nine months of the calendar year show that business generally has been moving ahead satisfactorily. What the effect of the present disturbance will be, it is safe to predict no one can foretell. Those who have been caught in the market probably will economize. Economy usually begins with luxuries, so that one may expect those industries which make and dispense luxuries to suffer some contraction in sales.

The concerns which have enjoyed good business during the first nine months of the year, have built up their surplus from earnings, and have kept a proper proportion of their assets in liquid form, probably will have little difficulty in continuing their cash dividends. Those corporations whose surplus is based in any substantial amount on assets which are priced at market values will be faced with a more difficult situation.

The get-rich crowd of individuals who were enamored of the market generally is sad to behold. The plodders who have saved their money and invested it intelligently, even in common stocks of conservative and substantial corporations, probably have nothing to fear on account of their investments. In relation to the market, many high-grade stocks, purchased a year ago, show a loss. In relation to the book value and dividend yield, they are as good as they ever were. All things are relative.
In the requirements for the listing of investment trusts recently promulgated by the Stock Exchange, a provision was incorporated to the effect that investment trusts should not include stock dividends in their income accounts. In recent weeks, the wisdom of this ruling has been the subject of discussion between the Stock Exchange and representatives of many companies affected by its operation, and a special committee has been looking into the question of stock dividends from the point of view of the Exchange with a view to clarifying the issues involved.

Based on the report of this committee to the Governing Committee, the following statement of position is made: The interest of the Stock Exchange in the method by which companies account for stock dividends arises out of its consistent policy of attempting to obtain, in connection with corporate returns, such a clear disclosure of the relevant facts as will enable the investor to properly appraise the listed securities in which he is interested.

The stock dividend has, in late years, become an important instrument in the financial policy of American corporations, and there can be little doubt that its use is still in the early stages of development. In particular is it of value to corporations in growing industries requiring the use of large additional amounts of capital, as it permits them in some measure to obtain this capital in the simplest manner from their own stockholders, and, at the same time, permits these stockholders, if they are so inclined, to realize upon their share of current or past earnings so capitalized. Coincident with the development of the stock dividend, there has taken place the development of the less than $100 par and of the no par value stock, together with the practice of having large capital or paid in surpluses; and these relatively new conceptions have led with increasing frequency to the corporate practice of partial or complete recapitalization through the form of so-called “split-ups.”

As a matter of definition from the point of view of the Exchange, a true stock dividend represents the capitalization, in whole or in part, of past or current earnings; while a split-up has not necessarily any relation to earnings and may mean nothing more than a change in the form in which ownership in an existing situation is expressed.

Accounting practice, in striving to adapt itself soundly to these important developments in corporate procedure, has not yet reached the point where a mere perusal of the year's accounts will suffice to reveal to the average investor in what manner he has been affected by action taken during the year in the matter of stock dividends. On this account, it is felt that the Exchange is justified in seeking to obtain wherever possible for the benefit of the investor such supplementary information as may assist him to a correct understanding of the accounts themselves.

Applications for listing which involve questions relating to stock dividends will be considered in the light of the foregoing. In view of the large and constantly increasing number of listings on the Exchange, either originating in stock dividends or involving questions that have to do with stock dividends, an effort will be made to obtain for the investor such information as may place him in the position to determine in connection with stock dividends received by him, to what extent they constitute true stock dividends representing the capitalization of current or past earnings, and to what extent, if at all, they represent merely split-ups involving an expression in a new form of what was already his. In any event, it is felt that the individual investor should make such independent investigations as seem desirable in order to be quite sure that he understands in each instance how he has been affected by the declaration of a stock dividend.

When stock dividends are received by investment trusts, holding companies or
other corporations, the manner in which these dividends are accounted for by the receiving company presents a problem somewhat different from that attending the accounting for the payment of stock dividends by the declaring company. Current practice varies all the way from the policy of ignoring stock dividends in their entirety in the income account of receiving companies, to the policy of taking them into the income account whether they have been realized upon or not at the full market value on the date received.

Uniform accounting practice today seems to favor as sound procedure the ignoring of stock dividends in the income account of receiving companies. However, it has been urged on behalf of investment trusts, holding companies and others, with what seems to us to be some measure of justification, that a technical interpretation of the nature of stock dividends may operate to hamper management in the adopting of perfectly reasonable and proper dividend programs of their own, whether in cash or in stock, and may even under certain circumstances force them as recipients, for technical reasons, to realize upon stock dividends which for business reasons they would have preferred to hold.

It may be that accounting practice will undergo certain modifications in the light of these new tendencies, but it is too early to form an opinion as to the direction that this modification is apt to take. It is possible that a schedule of all stock dividends received will suggest itself as a desirable addition to the annual report of investment trusts, holding companies and others; or, conceivably, a new departure in accounting theory may permit the inclusion of stock dividends in some form or other in the income accounts of receiving companies.

At the present time, it appears as if the Exchange could go no further than to take the position that it will raise no objection to the method by which investment trusts, holding companies and others account for stock dividends received by them and not realized upon, provided there is the fullest disclosure of the procedure adopted, and provided that these are not included in the income accounts of the receiving companies at a greater dollar value per share than that at which they have been charged to income account or earned surplus account by the paying companies. The manner in which receiving companies account for stock dividends received by them and realized upon during the period under review is a matter which the committee will pass on in connection with each specific instance.

RICHARD WHITNEY,
FRANK ALTSCHUL,
ROLAND L. REDMOND,
J. M. B. HOXSEY,

September 4, 1929.

Recommended to the Governing Committee by a joint meeting of the Law Committee and the Committee on Stock List, held September 9th, 1929.

Ashbel Green, Secretary.

Adopted by the Governing Committee, September 11, 1929.

Ashbel Green, Secretary.

Investment Trusts
(Continued)
I—Survey (Concluded)

A SECOND practice relative to the receipt of stock dividends is to assign a value at market, and to credit that amount to income. This practice has been followed by one of our important investment trust clients.

The ordinary procedure of this client on selling securities is to take profits on the basis of the average book value of all shares held. If shares received into investment account as stock dividends were sold, the utilization of the average book value basis would result in taking into income not only the market value of the shares at date of receipt, but also a sales profit corresponding to the amount by
which the book price of the stock was averaged down from that market value. To avoid this it seems clear that at least in cases where the sale is practically simultaneous with the receipt, average book value basis should not be used. This question has not arisen in practice, however, as our client has been accumulating the shares of the principal issues on which stock dividends have been received and has sold none of these stocks.

A third practice is one which has recently been given prominence by a ruling of the New York Stock Exchange affecting companies desiring listing. This ruling, which was dated September 4, 1929, and is separately reproduced in full herewith (pages 70-71), provides that the recipient may value stock dividends at their stated value as charged to earned surplus by the issuing corporation, and may take that amount into income. The Exchange has not made a general ruling on accounting for stock dividends sold.

Shown graphically, these three general methods of treating dividend shares received (when the dividend shares are substantially identical with the old shares) are as follows:

<table>
<thead>
<tr>
<th>Dividend Shares Not Sold</th>
<th>Dividend Shares Sold</th>
<th>Excess of proceeds over averaged cost (after taking up dividend shares at no price)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value practice...</td>
<td>Market value</td>
<td>Entire proceeds.</td>
</tr>
<tr>
<td>Stated value practice</td>
<td>Stated value as</td>
<td>Stock Exchange has not made a general ruling</td>
</tr>
<tr>
<td>(as prescribed by New</td>
<td>charged to earned</td>
<td></td>
</tr>
<tr>
<td>York Stock Exchange)</td>
<td>surplus</td>
<td></td>
</tr>
<tr>
<td></td>
<td>by issuing corporation. Stock Exchange has not made a general ruling</td>
<td></td>
</tr>
</tbody>
</table>

In the case of subscription rights, Federal income tax regulations provide that a part of the cost of the old shares shall be allocated as cost of the rights, on the basis of the respective market values of the shares and the rights. If the rights are exercised, no question of credit to income arises; under tax procedure, the new stock is taken up in investment account at the allocated cost of the rights plus the subscription cost. If the rights are sold, that part of the proceeds which exceeds the allocated cost is returned as income. Alternatively, however, the stockholder may credit to income the entire proceeds of sale of the rights, without assigning any cost to them. This alternative tax procedure creates a presumption that a credit of the entire proceeds to income would be justifiable for all purposes, and some of our clients follow that procedure. In practice, the amounts involved have been relatively small.

The propriety of including in income stock dividends received and not sold and the basis of their valuation are questions which have been revived today in difficult and important forms through a combination of three new factors in American finance: (1) the rapid spread of the practice of paying dividends in stock rather than in cash, (2) the great advance in stock prices, and (3) the concentration in single investment accounts, resulting from the formation of investment trusts, of large blocks of stock-dividend issues.

The Supreme Court settled that stock dividends are not income for tax purposes to the stockholder. As to whether they are income to the stockholder for other purposes, opinion has been divided. The weight of accounting opinion has probably been against their being so considered. Up to recently, however, no practical cases involving large amounts have arisen, with the result that the question has been a somewhat academic one and has perhaps not received the thorough consideration which it now demands.

The Stock Exchange has been confronted with this question, and in its recent ruling, already cited, it announced that "at the present time it appears as if the Exchange could go no further than to take the position that it will raise no objection to the method by which investment trusts, holding companies, and others account for stock dividends received by them and not realized upon, provided there is the fullest disclosure of the procedure adopted, and provided that these are not included in the income accounts of the receiving companies at a greater dollar value per share than that
at which they have been charged to income account or earned surplus account by the paying companies. The manner in which receiving companies account for stock dividends received by them and realized upon during the period under review is a matter which the Committee will pass on in connection with each specific instance."

The phraseology of the paragraph quoted, as well as of the discussion leading up to it, makes it evident that the Exchange has not closed the door to possible future modifications in the direction of permitting income credits on a more liberal basis. It is a question of such complexity as to make it extraordinarily difficult to lay down any general rule which would ignore the facts in individual cases. For reasons set forth in an attached memorandum, which we have prepared on the subject, it appears that there is much to be said for the practice of taking stock dividends into income at market value, and that it would be extremely difficult to maintain a position of rigid opposition to the practice. (See Part II below).

Our attached discussion is by no means adequate. It will probably be some time before the last word on this complex and controversial subject will be said. Meanwhile, the problem presses on us as auditors in a highly practical form, and as a working basis of action the following tentative solution is offered: that we permit the credit of unrealized stock dividends to income, provided (1) that the item is separately set out in the income statement, (2) that the investment account as a whole including the dividend shares is conservatively stated, and (3) that any excess of such credits over the stated value of the stock dividend as charged to earned surplus by the issuing corporation not be used by the receiving corporation for the payment of cash dividends. It is probable that the third proviso will in any case be followed by such corporations as are conservatively advised by counsel on the legal aspects of the subject.

In order to understand the full significance of this solution, it is necessary to realize that a stock dividend has been defined by the New York Stock Exchange as “the capitalization, in whole or in part, of past or current earnings.” Obviously, then, the dividends have been declared out of earned surplus, but in stock rather than in cash. To the extent that they represent earned surplus, stock dividends may be regarded as income, or as an addition to earned surplus of the recipient. If the recipient elects to take stock dividends into his accounts at an amount higher than the stated price at which they were transferred from earned surplus to capital by the issuing company, he should credit to unrealized appreciation the excess of market price over stated price. In the last analysis, however, the matter of importance is to insist that cash dividends not be paid out of any excess of market price over stated price; otherwise a qualified report would be inevitable.

As a broad conclusion to this survey we may well reemphasize the fact that great corporations organized to carry common stocks as their principal body of assets are, in the enormous development of the last few months, practically a new phenomenon. Along with this development, and intimately related to it and to each other in a variety of ways, there have occurred an unprecedented industrial expansion, and unexampled public demand for equity securities and a rapid spread among corporations of a policy of paying stock dividends. This combination presents new problems of such difficulty, or old problems in such difficult new aspects, as may require a searching reconsideration of some of the established maxims of finance and accountancy.

II—Valuation of Stock Dividends Received

The nature of a stock dividend, i.e., whether or not it is income to the recipient, is a question which the Court of Appeals of New York State as recently as December, 1928 (250 N. Y. 1) characterized as an “inveterate controversy.” The inclusion in income of a stock dividend received and not sold is frowned on by
numerous authorities. The objections to it are based mainly on the decision and the legal and economic doctrines referred to in the decision of the United States Supreme Court in 1920 (252 U. S. 189) that Congress has no power under the Constitution to tax without apportionment stock dividends as income. This case arose in connection with a stock dividend of 50 per cent of the true type, issued in January, 1916, by Standard Oil Company of California in $100 par value stock and charged to surplus at that value per share.

The decision was by a majority, Justices Brandeis, Clarke, Holmes and Day dissenting. The opinion of the Court rested on (1) what it called the "characteristic and distinguishing attribute of income," namely, that it is "derived from capital . . . not a gain accruing to capital . . . but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital . . . and coming in, being "derived," that is received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal; that is income derived from the property" and (2) the fact that "the same fundamental conception is clearly set forth in the Sixteenth Amendment" to the Constitution, namely, that Congress is empowered to tax without apportionment "'incomes, from whatever source derived'."

"The essential and controlling fact," the Court said, "is that the stockholder has received nothing out of the company's assets for his separate use and benefit. . . ." But the Massachusetts Court in 1917 (227 Mass. 522), in a decision holding that a stock dividend was taxable as income under the 44th Amendment to the Constitution of Massachusetts, had pointed out that "in essence the thing which has been done is to distribute a symbol representing an accumulation of profits, which instead of being paid out in cash is invested in the business, thus augmenting its durable assets. In this aspect of the case, the substance of the transaction is no different from what it would be if a cash dividend had been declared with the privilege of subscription to an equivalent amount of new shares." It is evident that this is so, that the effect of the distribution of a true stock dividend on the books of the corporation and on the cash and investment of the stockholder is precisely the same as if a cash dividend had been distributed and the cash had then been returned as a subscription to new stock. Justice Brandeis saw this clearly when he said, in his dissenting opinion, that "the equivalency of all dividends representing profits, whether paid in cash or in stock, is . . . complete."

The majority of the Supreme Court was able to make no reply to the merits of this conclusive elucidation of the essential character of a true stock dividend as income. The rejoinder of the majority was an irrelevancy, the door for which had been left open by a certain lack of precision of language in the Massachusetts decision, referring as it did to the identity of the two kinds of dividends in substance, whereas their identity in effect was evidently what was meant. The irrelevant answer of the Supreme Court was that a transaction where the stockholder, as in the case of one receiving a stock dividend, had no option regarding the final disposition of the cash, could not be regarded as identical in substance with a transaction where a stockholder, as in the alternative case, had such an option.

Obviously unable to rest its decision on the essential character of a stock dividend, the Court then proceeded to a point of Constitutional construction, saying that "the Massachusetts Court was not under an obligation, like the one which binds us, of applying a Constitutional amendment in the light of other Constitutional provisions that stand in the way of extending it by construction." It is thus on the following reasoning that the decision implicitly seems to rest: (1) while it cannot be denied that the effect of the distribution of a stock dividend is the same as the distribution of a cash dividend plus a return of the cash as a subscription to new stock, nevertheless the transaction in practice short-cuts this procedure, eliminating the intermediate transfers of cash; (2) as the
Constitution forbids the laying of direct taxes without apportionment among the States, a strict construction of the amendment granting power to tax income without apportionment is necessary; (3) strict construction of the language of the amendment permitting taxation, without apportionment, of "income from whatever source derived" makes it impossible to ignore the fact that the intermediate operation of "deriving" the cash has been eliminated.

The decision of the Court thus appears to rest on a question of Constitutional construction and not on the essence of the transaction. This decision by the highest legal authority is of course conclusive as to the absence of legal power residing in Congress to tax stock dividends, but it is scarcely so as to the justification of the stockholder in regarding a stock dividend as income.

It is a favorite argument that there is no income to the stockholder in a stock dividend for the reason that his holdings after the distribution represent no greater equity in the business than did his original holdings. The total equity remains the same and the equity per share is reduced. This is illustrated by assuming a corporation with a capital account of $100,000.00, representing 10,000 shares and a surplus account of $10,000.00; assuming also the declaration of a 10 per cent stock dividend by charge against surplus at $10.00 per share. The total equity before stock dividend is $110,000.00, or $11.00 a share on 10,000 shares outstanding; after stock dividend the equity is similarly $110,000.00 (all capital, no surplus), or $10.00 a share on 11,000 shares outstanding. The equity per share has been reduced. But this constitutes no argument against defining the stock dividend as income to the stockholder, unless it is to be regarded as equally valid against so defining a cash dividend. For if instead of the stock dividend in the above example a cash dividend of $1.00 a share were declared by charge against surplus, the equity after dividend would be $100,000.00 or $10.00 per share. The equity per share has been reduced precisely as in the case of the stock dividend.

Let us carry this a little further. Assume two corporations, X and Y, identical in structure with the one in the above example. Mr. A holds all the stock of corporation X and Mr. B holds all the stock of corporation Y. Each bought his 10,000 shares of stock at $10.00 a share and carries them on his books at cost, $100,000.00. Corporation X declares a stock dividend as above, and corporation Y a cash dividend as above. On the theory that A has realized no income he would carry 11,000 shares on his books at $9.09 a share or a total of $100,000.00, representing a total equity on the corporation's books of $110,000.00; B would continue to carry 10,000 shares on his books at $10.00, representing an equity of $100,000.00. Why should A be required to write his stock down to $9.09, while B is permitted to carry his stock at $10.00? There seems to be no logical reason. Suppose a free market for these stocks to exist, and A to represent the combined stockholders of X, and B to represent the combined stockholders of Y. Suppose the market to be an ideal market in which earnings are capitalized at 10 per cent and stocks go off proportionately at dividend record dates. These stocks are quoted at 10 and on an annual declaration of 10 per cent or $1.00 go off to 9, gradually building up again to 10. The theory that A has realized no income might in this case be bolstered up by insisting that his 11,000 shares are worth at the market only $9.00 a share or thereabouts. But if that is so, what about B? Should we not insist that B write off $1.00 a share against the income credited on receipt of the cash dividend? But we would not insist on that, presumably on the theory that the re-accumulation of a new surplus will gradually restore the price to $10.00. There seems to be, then, no justification for discrimination against A—for insisting that while B through his cash dividend has acquired resources of $10,000.00 available for income purposes, A cannot be allowed to incur operating expenses in a similar amount without being deemed to have impaired his capital.

(To be continued)
Additions to the Library

Ayer, Leslie J. and Ashley, Paul P. *Cases on Business Law, Selected with Notes and Problems.* (New York, Prentice-Hall, 1929. 1064 p.)


Knight, T. C. *Commercial Air Transport Accounting.* (Los Angeles, Charles R. Hadley Company, 1929. 4 p.)

Pinkerton, Paul W. *Accounting for Surplus.* (New York, The Ronald Press Company, c1924. 120 p.)


United Typothetae of America. *Standard Cost Finding System Set.* (Chicago, United Typothetae of America, 1928. 26 forms.)


Vickery, B. G. *A Guide to the Main Changes Effected by the Companies Act, 1929, Affecting Accounts and Auditing.* (St. Albans, Metropolitan College, 1929. 24 p.)

Mr. Cyril B. Dooley

The New York 45th Street Practice Office departed from its duty of serving clients, on October 3, long enough to congratulate Mr. Cyril B. Dooley on the completion of his twenty-five years with Haskins & Sells. The congratulations took on a substantial form when Mr. Dooley was presented with a check from the firm in token of its appreciation of his long and faithful service.

Mr. Dooley, known to many as “Cyril,” began his career with Haskins & Sells as an office boy. Then, with the growth of the firm, came the need for a “stationery department,” and Mr. Dooley was placed in charge. During the war his service was interrupted when he enlisted “to do his bit.” Upon his return he was made chief file room clerk and, with the opening of the uptown practice office, was transferred, where he has since been custodian of the increasing volume of reports issued by that office. Interested in his work, capable and conscientious, there is no file called for that he does not speedily and cheerfully produce.

We extend our congratulations to Mr. Dooley, and wish him many more years of happy, useful service with H. & S.

News Items

Colonel Carter was elected President of the Accountants Club of America, Inc., on November 18, 1929.

Mr. O. N. Hutchinson, manager of the Charlotte office, was elected President of the North Carolina Association of Certified Public Accountants, at its annual meeting in October.

Mr. R. N. Rigby, of the Boston office, is conducting an evening course of eight weeks on income taxes, at the Bentley School of Accounting and Finance, in Boston. Mr. Rigby is a graduate of the school.

Mr. C. W. Swormstedt, of our Cincinnati office, read a paper at the meeting of the Cincinnati Chapter of the National Association of Cost Accountants, on November 7, on the subject of keeping books on the basis of cash records and disbursements.