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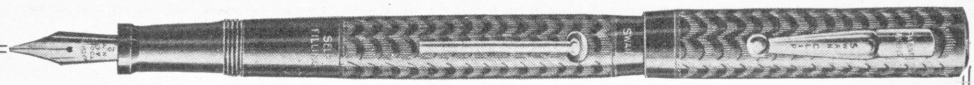

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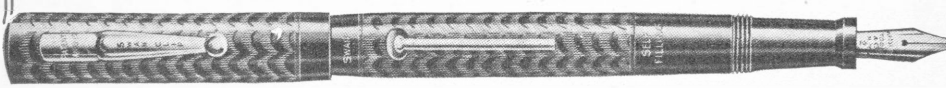

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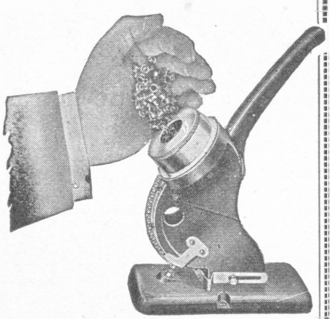

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The annual meeting of the American Institute of Accountants will take place Tuesday and Wednesday, September 19 and 20, 1922. The regular meetings of Council will be held on the 18th and 21st.

All meetings will take place at the Hotel Drake, Chicago, Illinois.

Persons interested in accountancy are invited to attend the open sessions of the general meetings on the 19th and 20th.

Inquiries may be addressed to the chairman of the committee on meetings, Charles R. Whitworth, 10 south La Salle street, Chicago, or to the offices of the Institute, 135 Cedar street, New York.

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*The* JOURNAL *of* ACCOUNTANCY

*Official Organ of the* AMERICAN INSTITUTE OF ACCOUNTANTS

Vol. 34 JULY, 1922 No. 1

# Present-day Problems in Industrial Accounting*

By STANLEY G. H. FITCH

The title adopted for insertion in the printed announcement of this meeting prior to the preparation of this paper purposely allowed wide latitude in the scope and treatment of the subject. Furthermore, at an informal summer meeting, I hope I may not be held to a too strict accountability if some of my remarks should prove to be somewhat irrelevant to the subject.

In selecting for discussion some of the many present-day problems in industrial accounting, I found it difficult to decide what problems were of first importance, because so many questions are continually arising in daily practice which at the instant seem to hold the centre of interest.

Broadly speaking, most accounting problems which we have to solve may be viewed from the standpoint of the balance-sheet. It may be argued that questions relating to the profit-and-loss statement should be separately grouped, but, after all, any transaction affecting the profits necessarily affects also some balance-sheet item, either an asset or a liability, so that for the purposes of this paper I propose in general to adhere to the balance-sheet as the base from which to approach the problems which I have selected for discussion, out of a great many which might have been chosen.

The balance-sheet itself as to form and arrangement presents at once a problem of paramount importance, and in developing the subject we might naturally proceed to take up questions relating to the treatment of the several balance-sheet groups. Some may be wondering how such a treatment of the balance-sheet is going very far toward the discussion of problems in industrial accoun-

*An address delivered at the fourth New England regional meeting of the American Institute of Accountants at Boston, Massachusetts, June 5, 1922.

ting, so here I might say that cost accounting, a highly important branch of industrial accounting, involving the application of overhead expense to the cost of product, has a direct effect upon the subject of inventory valuation, which brings us back at once to the balance-sheet. This topic will receive further attention later in this article.

## Form of Balance-sheet

Much has been written on the subject of a standard form of balance-sheet, but a casual reference to a few forms prepared by banks and bankers, which have been selected at random, discloses a striking lack of uniformity among those commonly used.

I should like to put the following question: In submitting a certified balance-sheet should the accountant follow the form prescribed by the client's bank or by the broker who handles his paper, or should he adopt a form of his own, which in his judgment, owing to the peculiar circumstances of the case, sets forth clearly the client's financial condition, with particular emphasis upon certain outstanding features disclosed by the audit?

I do not propose to answer that question, but for the purpose of laying the foundation for discussion, which I hope will follow, I shall mention some of the significant variations in three selected balance-sheet forms, designated for convenience as "A", "B" and "C".

*Current Assets:*

Balance-sheet "A" classifies as current assets, cash, notes and accounts receivable, inventories, quickly marketable securities and notes and accounts due from officers, stockholders and employees. Balance-sheets "B" and "C" include as current all of the foregoing assets except notes and accounts receivable from officers, stockholders and employees. Such items in many instances may be slow in realization, but in the other cases they may be quick assets and, for the purpose of setting forth the assets available for meeting current liabilities, they should be included under those conditions as current assets.

Balance-sheets "A" and "B" make no provision for subdividing the asset items for notes, accounts receivable, merchandise or securities, so as to show what has been pledged as security for loans, while balance-sheet "C" assembles in a separate group all pledged current assets (notes and accounts receivable, acceptances, merchandise and securities). This arrangement shows at a glance the total amount of such assets pledged but, on the other hand, makes it impossible without recasting the balance-sheet to state the total amount of each asset, pledged and unpledged. Balance-sheet "A" very properly indicates that reserves for bad debts, discounts, allowances, etc., should be deducted from the asset, while balance-sheets "B" and "C" provide for reserves upon the liability side of the balance-sheet. Inasmuch as the purpose of the balance-sheet is to show the net amount likely to be realized from the liquidation of any current asset, the former method is to be preferred.

Balance-sheet "A" does not provide, however, for a separate classification of notes and accounts due from controlled or subsidiary concerns, and, while such a subdivision is made on balance-sheets "B" and "C," the items are not classified as current assets. It may be pertinent to remark, however, that a scrutiny of the balance-sheets of the subsidiaries might disclose that the balances due the parent company were offset almost wholly by current accounts and notes receivable from customers, so that in reality the balances due from the subsidiaries on the parent company's books actually represent assets more "current" from the standpoint of quick realization in cash than inventories classified as current assets on the balance-sheet forms in question.

*Current Liabilities:*

All three balance-sheets ("A," "B" and "C") include as current liabilities notes payable, accounts payable and accrued items (taxes, interest, etc.), while on balance-sheets "B" and "C" are set forth as separate items dividends declared and payable. Balance-sheets "A" and "B" clearly indicate the separation of notes payable as unsecured and secured respectively, but the amounts are grouped so as to show the total notes payable, while balance-sheet "C" shows notes payable, secured by notes receivable, accounts receivable, trade acceptances, merchandise and securities as a separate group. This arrangement is open to the same criticism as applied to the relative pledged assets: that it does not disclose at first glance the aggregate of an important liability, viz., notes payable, including both unsecured and secured notes.

It is worthy of note also that in balance-sheets "B" and "C," notes and accounts payable to controlled or subsidiary concerns are included in current liabilities, while, as previously mentioned, notes and accounts receivable of similar concerns are excluded from current assets. If such accounts and notes payable by the parent company to the subsidiaries represent deferred liabilities, they can properly be excluded from the current liability classification.

*Fixed Assets:*

While the three balance-sheets under discussion differ as to degree of detail in stating the fixed assets, there are two important variations calling for comment: first, balance-sheet "A" provides for the deduction from the fixed assets of the reserve for depreciation, while balance-sheets "B" and "C" indicate no such application of depreciation reserves in reduction of the respective assets but show the reserves on the liability side of the balance-sheet. The former method is to be preferred in that it shows at once the net book value of the fixed assets and precludes the inclusion of the reserves with surplus. Secondly, on balance-sheet "A" goodwill is deducted from the total of capital stock and surplus in stating net worth, while on balance-sheets "B" and "C" goodwill is shown in the usual way on the asset side of the balance-sheet. In some circumstances, where goodwill is carried at an inflated value, the former method would no doubt be justifiable, but in other cases, where goodwill has a clearly demonstrated value, the virtual writing off of the goodwill value would be far from a correct procedure.

Other comparisons could be drawn from the balance-sheet forms under discussion, but enough has been said to show clearly the need for further development toward standardization.

I might add that the balance-sheet forms selected for comparison could in no way be classed as freaks; they were issued by three leading banks. If any attempt had been made to analyze the variations in form shown by some less carefully prepared balance-sheets, even more striking inconsistencies would have been disclosed.

I believe that public accountants and bankers both realize the advantages that would accrue to all parties at interest if a form of balance-sheet could be evolved which would be accepted generally as standard. An interesting announcement appeared in the bulletin of the American Institute of Accountants, dated May 15, 1922, to the effect that a committee of the Robert Morris Associates (an organization of credit-men of banks) was recently appointed to investigate the question of closer coöperation with public accountants. This was followed by the appointment of a committee of the American Institute to meet and act with the representatives of the Robert Morris Associates. I venture to express the hope that one result of the contemplated joint work of the two committees may be some contribution toward the standardization of balance-sheets.

### Valuation of Inventories

The valuation of the inventory at the balance-sheet date determines to a great extent the profit or loss for the prior fiscal period and the financial condition at the close. Consequently, the inventory is rightly subject to close scrutiny on the part of those concerned in granting credit on the basis of the balance-sheet submitted.

Some of the questions usually asked are these:

Was a physical inventory taken or does the inventory reported represent a book balance with or without supporting perpetual inventory records?

If a physical inventory was taken, did the auditor assist in or supervise the actual counting, weighing and listing of the stock?

How was the inventory valued, i.e., at cost or at cost or market whichever was lower?

How were cost values and market values ascertained and does the company operate a cost system?

Were the calculations and footings carefully checked to obviate clerical errors, which, while unintentional, have the same effect as deliberate falsification of the inventory?

And, finally, to what extent did the auditor verify the work of the client's force, and how far is he responsible for the value reported?

The manner in which the inventory is shown on the balance-sheet, in conjunction with the auditor's certificate thereto, should be a satisfactory answer to the last question.

### Cost Accounts in Relation to Inventories

I cannot, however, dismiss the inventory problem without some particular reference to cost accounting in its relation to inventory valuation. We all admit that in ascertaining costs, an allowance for overhead should be included and opinion is fairly unanimous that overhead so included should be limited to that relating to manufacturing or production, as distinct from selling and general expenses. But in times of depression, overhead costs soar, while the increase in direct costs is relatively small. In the case of merchandise manufactured under such conditions, should it be inventoried at actual cost, which means virtually the absorption of losses directly attributable to idle capacity?

Aside from the accounting aspect of the case, what is the effect on the balance-sheet offered for credit purposes? Balance-sheets of borrowers are now perhaps more than ever before subject to searching scrutiny by bankers and credit-men, and in a great number of cases their attention is focused upon the inventory as the key to the borrower's financial condition. The familiar phrase describing the valuation of the inventory as "cost or market whichever is lower" may possess special significance. What does "cost" mean, especially with reference to finished product manufactured when production is far below normal? Does "cost" mean that actual overhead charges have been loaded upon the merchandise, thereby inflating the book value by inclusion of unearned overhead which should have been charged to profit-and-loss? Is it truthful to say "merchandise is valued at cost," when in effect the inventory includes deferred charges to profit-and-loss, which should have been written off in the period just closed, instead of being carried forward as a burden to be taken up in the ensuing periods?

The answer is "No." In my opinion the solution is the use of normal or standard costs for inventory valuations. Then the merchandise can be fairly valued and the loss arising from idle plant can be ascertained and intelligently treated.

Obviously the only fair cost to use in the valuation of an inventory is a normal or standard cost. If that basis has been used, supported by details drawn from the cost records, the borrower will be in a strong position to maintain his credit with his banker, while if the other basis has been used, i.e., inflated values arising from excessive overhead in costs, the credit-man's mind is at once charged with doubt as to the soundness of the borrower's balance-sheet.

### Inclusion of Interest on Capital in Cost, and the Effect on Inventory Values

I do not propose to start any argument as to whether or not interest on capital should be included in costs, but to point to a practical difficulty which is encountered when such interest is included in costs. By interest on capital, I mean interest computed on capital invested in the assets employed by a manufacturing plant, which is charged to manufacturing costs and credited to income or to profit-and-loss; in other words, an imaginary transaction and not an actual outlay.

In the operation of a highly developed cost system, which recognizes interest on capital as an element of cost, it is customary to allocate to each manufacturing department its proportion of such interest and to include that interest in the departmental overhead which is distributed to production centres or to individual machines. Such overhead (including interest) is absorbed in the cost of the product which passes through the several departments. Consequently, if we take as an example a finished machine, the product of a textile machinery plant, the cost is represented by the aggregate of the costs of a multiplicity of parts, made in different departments, including a proportion of the charges for interest on capital allotted to the respective departments but merged with other overhead charges.

If the interest charge is allowed to remain in the cost of that machine for inventory purposes, we have an inflated value arising from the inclusion of an unrealized profit. That truth, I believe, is generally recognized by the proponents as well as the opponents of interest as an element of cost. In arriving at a proper inventory basis there remains, then, only one further step, and that is to eliminate the interest from the cost of the finished product. That sounds very simple, but actually it is practically impossible, because the identity of the interest charges has been lost in the distribution of the overhead, and the process can be reversed only with extreme difficulty. I have seen detailed instructions, accompanying most excellent cost systems, for the inclusion of interest in cost, but I have never seen similar detailed instructions for the elimination of said interest from the cost of the finished product, if such be required.

### Purchase Commitments for Future Delivery

Recently many losses entailed in deflating inventory values were recognized and taken into account in preparing annual balance-sheets, but other similar losses arising from purchase-contract commitments for future delivery could only be approximated.

During the period of deflation in commodity prices, through which we have just passed, great stress was rightly laid upon the borrower's purchase commitments and their probable effect upon his ability to meet his obligations or perhaps even his prospects of continuing in business. In order to obtain supplies of materials it was necessary to make purchase contracts, and in a period of falling prices losses were in many cases unavoidable. Bankers justly required full information bearing upon the borrower's liabilities of that nature.

With the return to a period of stable prices, losses on commitments become less a cause for anxiety. We as accountants face the problem as to what extent we shall inquire into and report upon purchase commitments which are made in the ordinary course of business. One banker expressed the opinion that he was not interested in contracts made under such conditions; but others held opposite views.

### Obligations of the Auditor Under Bond Indentures, Capital Stock Issues, Etc.

The public accountant must always be on the alert for clauses in bond indentures and capital-stock certificates, which delegate to him definite responsibilities. Certified statements are frequently required under such conditions, but a study of the documents may develop the need for a legal interpretation of the meaning of a clause which may be construed in more than one way. Whose advice shall the auditor take in order to meet his responsibilities intelligently and properly?

In one case recently under consideration the definition of "quick assets" required careful interpretation. In another case the basis of the inventory valuation, as set forth in the indenture, could be construed in more than one way. In a third case the auditor was charged with the responsibility of determining what constituted "adequate" depreciation before certifying the profits available for dividends, and in a lean year he was forced to take issue with the corporation officers. The foregoing illustrations demonstrate the need that the auditor inform himself as to what his responsibilities are before he affixes his signature to a certificate.

### Form of Balance-sheet Certificate

A serious problem which I believe we shall always have to face is the use of the qualified certificate. The ideal conditions leading up to an unqualified certificate cannot always be realized. But the practice of issuing a statement which is merely a condensed copy of a trial balance, with a certificate stating in effect that the balances agree with the books and have not been otherwise verified, should in my opinion be discouraged, not because the accountant says he has done anything which he has not done, but because of the failure of many bankers and business men to read the certificate and to understand its significance. They see merely a balance-sheet statement over the auditor's signature and assume that it is an audited statement.

Not long ago, a banker expressed himself as unable to understand why a certain corporation had gone into the hands of a receiver within three months after issuing a satisfactory statement of condition over an auditor's certificate. Upon inquiry as to the form of certificate, the statement was produced which showed a "certificate" to the effect that the statement was only a condensed copy of the trial balance and that no audit whatever had been made. The fact was that the banker either did not read the certificate or did not realize its significance.

Our hope for a greater opportunity for service lies in educational propaganda to the end that the business community may realize more fully the value of the accountant's work and the importance of reading what the accountant states over his signature.

## Conflict between Established Accounting Procedure and Federal Tax Regulations

A problem which is only indirectly related to the balance-sheet is the conflict between established accounting procedure and federal tax regulations.

Many of us have frequently been asked by clients for counsel as to the advisability of adjusting their books to conform to the results of audits of tax returns according to federal tax regulations. Charges for depreciation and repairs have been a constant cause of dispute between the taxpayer and the treasury department, resulting in disallowances of such charges in many cases. Should the asset account, surplus account and depreciation reserve account then be adjusted upon the books? Obviously the bookkeeping would be simplified for future years by maintaining only one set of accounts, without the necessity of reconciling annually the figures shown by the books with those shown by the tax returns. On the other hand established bookkeeping procedure, adopted for valid business reasons, would thereby be upset and valuable comparisons rendered impossible.

One client who adopted the "cost or market" basis for his inventory decided to abandon the "cost" basis for bookkeeping, although that basis had been followed for years. He soon found, however, that to operate his cost system using cost or market was a complicated matter. The solution seems to me to be to keep the accounts on a cost basis and to make annual adjustments in the aggregate if it is desired to bring the accounts finally to a basis of "cost or market."

# Auditors I Have Known

By Mabel D. Paine

A well-known book on accounting tells us, "The accountant is a judge to whom appeals are made by the employer against the employee. . . . Bookkeepers are generally interested only in methods and devices which save them personal effort; they are apt to forget that they were not engaged to make their work easy, but to keep books in such a manner as to make them valuable to the employer." This statement drew a little gasp of surprise from one who, lacking wide or definite knowledge of the subject, had yet entertained a vague idea that bookkeepers were, on the whole, rather a hard-working and conscientious lot. That the public accountant may view them from a different angle is suggested by the author's further words: "Accounting . . . must war incessantly against carelessness, ignorance, inefficiency, evil-disposed cleverness and, possibly, against dishonesty." From a bookkeeper's point of view this sounds rather harsh, but it is plain that if all books of account were honestly and accurately kept, one of the prime causes for auditing would be non-existent.

Consideration of these different points of view raises two interesting questions: first, When (if ever) is a bookkeeper also an accountant? Accountancy seems to be the popular profession of the day. Doubtless the original impetus toward this popularity was given by the increasing complexity of the income and profits-tax return, for many an individual has thereby been driven to a knowledge of accounting terminology and methods which he would not otherwise have acquired; and the number of those who are "taking a course in accounting" is legion. A demonstrator of a widely-used calculating machine, commenting upon the fact that "this accounting is the thing nowadays," went on to say that he would very much like to secure a C. P. A. degree, that he might be prepared to show just how the machine could be made most useful in each individual business. He apparently thought that by devoting to this object one or two evenings a week, the desired end could be attained in the course of a season—a view which might be justified by the advertisements one reads, offering rich rewards in the field of accountancy to those who are willing to give up a little leisure time to the study. It is perhaps a logical sequence to these accounting courses that so many now advertise their qualifications for the position of "bookkeeper and accountant." Clearly, the man whose bookkeeping is limited to handling the A to K sales ledger, and whose practical knowledge does not exceed the requirements of that work, has no claim to the name of accountant; but what *does* constitute a private accountant?

For the other question—while a *bookkeeper* realizes quite poignantly that he is "known by his doings" to the auditor who goes over his accounts and that those accounts reveal much concerning his methods of work and himself, does the *auditor* in turn know that the process of appraisal is two-edged? For instance, one is aware that a capable auditor does not require the entire set of books at his elbow throughout the period of the audit; that it is far easier and more comfortable to be audited by a "first-class man" than by one of indifferent qualifications; that an accountant who is well-read and has had valuable experience does not try to impress that fact upon one, knowing perhaps that such qualities or attainments speak for themselves. Where the undertaking is so large that many auditors and many bookkeepers are concerned, the work must of necessity be more impersonal, offering less opportunity for individual observation. In all probability, the auditor would consider a bookkeeper's opinion a matter of negligible importance in any case, for one is sometimes tempted to believe that they look upon books of account as having been created for the purpose of being audited, while the bookkeeper, like the bridegroom at a wedding, is a rather essential but otherwise unimportant adjunct.

If a bookkeeper's experience has been such that he looks upon auditors as militant judges, set over him to ferret out possible misdeeds and to pass sentence upon him, then his opinions might very probably make rather lurid reading; but when one first comes into charge of a full set of books and at the same time learns that those books will be audited periodically, the chief feeling is one of curiosity, especially when the bookkeeper knows only enough to realize how infinitely much more there is to be known. Through years of audited work, one grows to be not only tolerant of the vagaries of these bothersome auditors, but grateful for their help; to study them with friendly interest; and even to cherish a certain wistful admiration for some acquaintances who have helped to bring accountancy into dignity as a profession and have made good in that profession—an achievement the more noteworthy because the accountant must build up his clientele largely from the ranks of business men and manufacturers, who have been prone to look upon accounting as an elaborated form of hairsplitting, scarcely worthy the consideration of a red-blooded man. But they are beginning to realize that it requires for true success broad knowledge and experience, not only of accounting itself, but of commercial law, of industrial conditions, of finance and, last but not least, of human nature.

Back in the days when income taxes had not yet appeared on the business horizon and when accounting practice had received scant notice at the hands of the legislature, an "expert accountant" of wide experience and a very green would-be bookkeeper formed an alliance which lasted over a dozen years and terminated only with the death of the accountant. The adjective "expert" is not quoted from himself but seemed to be more frequently used then than now to designate a public accountant. He had been asked to recommend improvements in the system and it now seems odd that the following suggestion should have represented a decided innovation to those interested in the books: "All cash receipts should be deposited in a bank and all payments for cash should be made by cheque and the cashbook so ruled that the discounts . . . should be placed in a column immediately to the left of the cash; . . . to provide for sundry small cash payments, a petty cash account to be kept entirely separate and singular," etc. Although there have been many changes and revisions since that first report was received and the work has increased in volume so that one pair of hands is no longer equal to the task, the cashbook more than any other remains the same in essentials. Had this petty cash fund been given the name now usually attached to it, that bookkeeper would not, in later years, have said to a very learned accountant, "But I know so little! Now, for instance, someone was talking the other day about an 'imprest account'." "Well," was the answer, "you know what that is." "Why, I never even heard of it!" A look of amusement flashed into the keen eyes as he retorted, "Nevertheless, you have been carrying one for a good many years." Suffice it to say that one bookkeeper thereupon set to work to learn a little bit more about accounts in general.

At the beginning of his association with the business in question, the first auditor was not a C. P. A., for the very good reason that no such degree had ever been created in the state. When the law was enacted he entered the opening examination with some trepidation, for examinations are doubly nerve-wracking when many years have elapsed since one has undergone the experience, but emerged with flying colors and an almost boyish satisfaction that the thing was well over, which it was good to see. One quality that enhanced his helpfulness, indeed, was his humanness. Accounts may be well and thoroughly checked on an absolutely impersonal basis, but if helpful service is to be part of the work, a bit of friendly interest is a great addition.

To each auditor who has appeared often enough to impress his image on an active memory, certain characteristics appertain; out of all that might have been remembered of this first service, two little details seem to stand out disproportionately to their importance. His material equipment was unfailingly complete and yielded fountain pens for both red and black ink, a miniature stamp and pad, pencils, erasers, even a ruler. One hastens to add that such small necessities would have been most willingly supplied, and yet the forethought that provided for even the least detail commanded respect. Also, it was his habit to make very neat and tiny check-marks! It is an absurdly small thing to remember so long, nor is he the only one of whom this might be said; but apparently an occasional auditor thinks fat red check-marks should be considered an ornament. One memory that brings a smile now relates to an auditor who devised and carried out a scheme for placing check-marks between the dollars and cents columns throughout the general ledger, right in the middle of each amount. Under this treatment, the familiar columns took on an oddly disconcerting appearance; the bookkeeper hoisted signals of distress, only to be informed that there was a reason for it. Since, however, the checker did not state that it was required "by the best accounting practice" or that it was "the proper procedure" (under either dictum a well-trained bookkeeper promptly wilts) the check-marks thereafter resumed their usual location. On the other hand, a carefully prepared list of insurance policies, submitted for verification, was returned by the account-ant-in-charge, checked with infinitesimal dots, because he had thought it a pity to mark up so neat a schedule—another trifling thing—but the thoughtful consideration was no trifle, and if a man's ability as an accountant is augmented by such qualities as tact, courtesy and appreciation of the other fellow's side, it must surely make him more successful and helpful.

Undoubtedly some of the devices which a bookkeeper works out to take care of special needs may appear very unconventional, even funny, to the auditor. Books on accounting do not always supply wanted information in an emergency. It is strange, however, to meet later in good accounting society some pet scheme fancied to be peculiarly one's own. Eager with a new plan, the bookkeeper one day said to the first auditor: "Why wouldn't it be a good idea to have a journal with columns arranged after *this* fashion?" "It would be excellent," was the laughing reply, "but a man invented that form of journal before you were born!" The writer is even now awaiting with some curiosity the auditors' opinion of a brand-new (?) arrangement for a rather bothersome account. Will they say, "Oh yes, that is often done"; or will the comment be, "I never saw that handled in such a manner," with a doubtful expression which conveys the opinion that it never *should* be so managed? At the risk of appearing over-sanguine, would it be impossible for a bookkeeper to devise some little scheme which, although it had not the sanction of precedent and convention, was yet good in itself? Have all the ideas been already developed?

To fall into the hands of a large accounting firm, after so long an association with one auditor, brings many changes. The bookkeeper looked up one day to behold an imposing procession advancing. Leading the way came "the chief," followed, in due order of precedence, by the principal accountant, senior and junior assistants. They were irresistibly suggestive of the Belvidere Male Quartette about to line up and break forth into song, and the waiting victim sternly repressed a chuckle. Three able-bodied men to audit the accounts of one harmless bookkeeper? The said bookkeeper's ignorance of customs in an accountant's office was so comprehensive that such terms as resident partner, senior and junior assistants and the like were then unfamiliar; but it soon became apparent that only two might be expected to remain.

It was natural that in taking up the work, this firm should hold some theories quite different from those prevailing before; natural, also, that a bookkeeper accustomed to one accountant's ideas should find it a little difficult to accept at once anything quite radically different; and so there arose an amicable but earnest argument as to the accrual of taxes—income taxes of a mild and simple nature having by this time arrived on the scene of action. This was another trifle, surely, to linger in one's mind, but the discussion closed by the auditor's saying, not with any air of superiority but in friendly fashion, "Well, anyway, you just think it over"; and sure enough, after the matter had been thought out, his conclusions seemed altogether reasonable. It would have been so easy to press the point in a way that would have offended instead of convinced.

That assistant-in-charge was a most courteous and kindly auditor and so good an accountant as well that all too soon (from one point of view) he advanced to larger undertakings, "gone, but not forgotten." Variety may be the spice of life, but as exemplified in auditors it contains elements of discomfort. So many have come and gone since then that they almost blend into a composite portrait with the light striking here and there on some marked feature; and be it said in all sincerity that the most pronounced feature is courtesy, differently shown but always present. Almost as generally characteristic are tact and kindliness. Although it might be thought that the two are synonymous, there is really a difference. For instance, it could not be reckoned the most fortunate way of introducing the subject for an auditor to say abruptly, "There is a lot of errors on this sheet," and that in a case where the figures had been prepared, checked and rechecked with meticulous care. The event proved that there were no errors, except in his method of handling or conception of the work; but no one felt even the slightest offense, because he had been uniformly kind, even though his tact may have failed now and then. Everyone knows the uneasy feeling induced by a dentist who probes here and there, asking, "Does that hurt? Is that sensitive?" seemingly just looking for trouble. Somewhat the same mental state results when an auditor appears really *eager* to find errors; but in truth such auditors have been exceedingly rare in the writer's experience. Perhaps, as an attorney remarked concerning the auditors of federal tax returns, "They feel they must find something incorrect, to justify their existence." One trait which has been almost universal among those who have worked in this particular office is a cheerful willingness to accommodate themselves to physical conditions, when for some reason the client has been unable to provide exactly the ideal place for them. If the heating plant is temporarily out of commission and a cold wave makes itself felt when warm weather should naturally be prevailing, they blithely remark that it was much colder in France and proceed undaunted with the audit. In fact, as a general thing, they seem oblivious of the surroundings and intent only on the work in hand.

Certain phases of an audit are a wee bit trying, even when the auditor is well-liked and the bookkeeper habituated. One accountant says that some people feel insulted at having their cash verified and it is true that on hearing for the first time, "Shall I count your cash now?" a still small voice somewhere in one's inner consciousness instantly responds, "You let my cash alone!" but that feeling soon vanishes. Affairs did look rather bad for the keeper of the cash when an attempted embezzlement (?) of fifty cents was brought to light and had to be acknowledged. Since it was the first offense, restitution was accepted as covering the crime and no mention was made in the report. Happily, the auditor who then called attention to a shortage was not the one who carefully unrolled all the nicely-wrapped currency in the drawer, in order to make a thorough count. Possibly it was only the cashier's lack of knowledge that made this seem a novelty; but if it is required by the proper procedure, it has never but that once come to notice.

It soon becomes natural to turn over for verification purposes everything connected with the accounts. Obviously, no accountant can certify to that which he has not actually seen; and it is odd that the only request which awakens the faintest shade of protest in one bookkeeper's mind is the call for current invoices, to be used in proving that no bills have been feloniously held back. After laboring strenuously to take up every liability before closing, one seems to feel a special element of suspicion in that demand. The search sometimes brings amusing results, as when a young accountant apologetically remarked that provision had not been made for a small contract. The service contract in question involved an annual amount of sixty dollars, paid in quarterly instalments, and he felt that, strictly speaking, the expense for two months and a half should have been accrued before closing. It was a pleasure to be able to assure him that, inasmuch as the quarterly amounts were payable in advance, there was really a prepayment of one-half month, although it had not been carried on.

What can one do when an accountant voices a most heterodox theory, declaring that his firm always bases its practice on that principle; when not even the bookkeeper's previous experience with the firm nor statements in *Regulations 45* nor any other argument will convince him of the error of his ways? The one time that this happened must have been due to temporary aberration, but left a marked impression on the hearer's mind. It remained for his chief to set him right. Any bookkeeper would be extremely foolish to feel elated over being found in the right when a question comes up, but he would be more than human if it were not a satisfaction, for it must be sadly confessed that bookkeepers are not infallible and the victim does wriggle most uncomfortably when confronted by the auditor with some error that has crept in, despite careful work. It is a comfort to find that Jove may nod occasionally. Anyway, an infallible person would be a terrible bore, and how would the auditors derive any satisfaction from their work if everything were found at a dead level of perfection? As one man feelingly remarked, "This constant checking pretty nearly puts me to sleep"; and another, "It's no fun checking books that have no mistakes." (He happened upon a lucky period when everything went right.) When an auditor intimates that the work lacks interest because it is all so "cut and dried," it awakens a mischievous desire to do something next time which, perfectly correct in itself, shall nevertheless set that accountant to guessing.

It is of course impossible for even a very good accountant to be familiar with terms and processes peculiar to every line of business where his lot may fall, but it arouses a queer little feeling of surprise when a man who knows so much betrays absolute ignorance of some matter which is as A B C to the bookkeeper. It happened one day that an auditor, about to check an inventory which included much paper stock, inquired the number of sheets in a ream. That was not strange—it is so easy to forget details not in constant use—and the answer was prompt, "Five hundred to the commercial ream." Then, "How many quires are there?" —which was also natural enough; but why, having learned that "twenty quires make one ream," should he ponder the matter for a moment and then propound a third question, "Well, how many sheets are there in a quire?" Or again, what difference could it make in the final result of an inventory of work in process, whether one reduced the accumulated minutes to hours at the bottom of each sheet or at the close? Why wait until the end, anyway, since the other method gives smaller amounts to handle? And when an auditor says in dignified manner that he "computed in a different way" a small technical problem that could have but one correct answer, why, one is curious as to how he could possibly do it, to reach a different result.

A sense of humor is a most desirable attribute in an accountant. Without it (and this is said with the utmost diffidence), is there not a little danger of an over-serious conception of the work? Imagination winces at the thought of what might have happened to the luckless wight in the following incident, had not the accountant, who justly enjoys a reputation as an authority in his chosen line, been gifted with that most helpful quality. Talking of a certain account, rather difficult to handle at first acquaintance, and unconsciously rushing in where angels might have feared to tread, the bookkeeper said, "Yes, I think I grasp its functions now; but it seems to me that treatise did not make it as clear as it might have done." Then, out of some vague memory, a dreadful thought took shape; surely his name had been connected with that work? "Did *you* write that?" And it proved to be even so. How the author might have frozen that rash critic, had he not chosen to laugh instead!

In a recent conversation with another wise accountant already mentioned, some question arose regarding general expense. "Well, for instance," he was asked, "wouldn't you class the auditor's fee as an indirect or general expense?" "Very general indeed," he replied, with a twinkle; "you might charge it up as a necessary or unnecessary evil, according to your point of view." Then and there it quite suddenly dawned upon his hearer with a little shock of astonishment that if it were possible to become an un-audited bookkeeper by simply expressing a desire, no such wish would ever be uttered; for, after all, there is a certain security and satisfaction in knowing that one's work has been weighed in the balance and not found wanting in essentials; and the bookkeeper who honestly wishes to do the very best and most valuable work possible has nothing to fear from "those auditors."

# Accountant and Banker*

By Spencer S. Marsh

To James G. Cannon of the old Fourth National bank in New York should be given the credit for having first created among bankers a desire to have their commercial loans supported by signed statements from the borrowers, showing their financial condition.

For many years bankers had been in the habit of granting loans to their customers, basing them entirely on the character of the borrower and the meagre knowledge of his business that could be gained from the way he conducted his bank account. This method of determining whether a loan was desirable or not was most unscientific and resulted in creating a wrong attitude on the part of the borrower toward the banker, in many cases giving the borrower a false sense of being injured when asked to furnish a statement of his affairs or questioned too minutely concerning his business.

Through the efforts of a group of men, among them Mr. Cannon, bankers in this country were led to see that they were entitled to statements from their borrowers, and gradually the borrowers were educated to a point where they could see that information given to their bankers was for their mutual good. Credit departments were organized in banks, their function being to keep careful and accurate records of all credit risks, securing statements from all borrowers at least annually, tabulating and analyzing the contents and translating the figures into a standard language that could be read quickly by the banks' officers.

The wisdom and vision of the men starting this movement is shown by one illustration. A large merchandising house of national reputation enjoyed the best of credit. Accounts were kept with several large New York banks. Banks all over the country purchased the paper of this house and its subsidiary companies in large volume from note brokers, taking the recommendation of its banks as to its worth.

The house became involved and failed. Nearly every bank in the country that was a purchaser of commercial paper held some of this paper and great surprise was expressed when it developed

*An address before the Society of Certified Public Accountants of the State of New Jersey.

that one of the large New York banks not only had none of the paper of the failed house, but had asked the concern to close the account formerly carried with it. When asked to explain the position in which this bank found itself, an officer answered simply: "Why, they would not give us a statement of their affairs and we will lend to no one unless he can and will support his application for a loan with a statement."

This experience had a great influence on banks throughout the country and probably did much to crystalize the opinion among bankers that unsecured commercial paper should always be supported by a statement. Before long dishonest merchants discovered that bankers could be fooled by false statements, and it was a natural suggestion that statements be made up by disinterested persons after an audit in a scientific manner.

This demand for accurate knowledge of a borrower's financial condition has grown until it is the general practice of the banks of the country to demand statements from borrowers and often to insist that these statements be made by independent persons. The result of continued education is shown by the willingness of dealers to supply statements and the large number of houses that now employ outside accountants to make regular audits and reports for the manager's own information and use.

Your president suggested that I discuss some of the points of contact between the banker and the certified public accountant. I shall take a liberal view of this text and in a general way try to tell you what a banker wants to know about a borrower and what he tries to get from the statement presented—whether it be made up by the borrower himself or by an accountant.

Better to understand the banker's point of view I think we should remind ourselves of several fundamental principles by which he is guided if he is true to his trust.

First: He is lending other people's money. He therefore wishes to surround his loan with the best scientific knowledge obtainable.

Second: It is the bank's function to supply credit, not capital.

Third: He must so guide his borrowers and limit his loans that his bank shall not become a partner in any business enterprise.

Fourth: This should perhaps have been first—he should base his loans on the *character, capacity* and *capital* of his borrower in this sequence. Any statements filed must help him to apply these principles in determining whether or not the loan is to be granted.

I think that bankers generally want to coöperate with the accountant and would welcome some method of standardizing as nearly as practicable the reports of your audits. I realize that many difficulties must be surmounted before this can be accomplished, but if your principal is told that when your report is to be submitted to his bank as a basis for credit it must contain certain vital information, it may help to surmount some of these difficulties.

When the report of your audit is placed before the officer who is to pass on the loan his first interest will be in the description of the audit made by you—to determine its scope and thoroughness.

This in a general way should recite whether or not the business under review maintains a proper set of books—that show its condition at all times—whether or not these books are run properly and kept in balance. This applies particularly to medium and small concerns, although some large enterprises are subject to criticism in this respect. If the business needs a cost system—state whether accurate or only approximate. The banker will quickly pass to the figures showing assets and liabilities, particularly those showing the quick assets and current liabilities. To be most helpful these should be grouped to show the subtotals of each so that comparison can be made quickly to determine the ratio of current debts to quick assets. The banker is not interested so much in the slower assets and permanent debts as he is in the former figures, for in large measure his decision will be determined by the excess of quick assets over liabilities shown in the statement. While this is so the slow assets should be shown in detail and should be subject of comment. A borrower's ideas of what constitutes a current debt and the banker's idea of the same kind of debt do not always agree.

Then the operating or profit-and-loss statement should have close scrutiny and should show comparison with former years. The slow assets often contain items that vitally affect the firm's credit standing.

To illustrate: A statement showing some three hundred thousand dollars' worth of quick assets in excess of current liabilities had among its slow liabilities an item of $350,000 that looked and acted like a mortgage on its plant. Investigation showed that this item covered notes given by the corporation to its stockholders in payment of money advanced by them to purchase the plant, with an understanding between the stockholders and the corporation that the notes would not become due for ten years. Nothing was in evidence, however, that would prevent the holders of these notes from demanding payment at any time.

This item should have been included among the current liabilities. It put an entirely different complexion upon the cash position as shown by the statement, as the charge wiped out the entire quick assets and could have been remedied only had the holders of the notes placed their money at the risk of the business.

Items placed among the deferred debts should be supported by schedules that explain them completely.

Under existing conditions two asset factors are of the utmost importance to the banker—the inventory and the accounts receivable. During the past year numbers of bankers have realized that the oft-repeated accusation has become true—that bankers under the stress of circumstances had become merchandisers. They are vitally interested, therefore, in knowing all the details possible concerning the borrower's inventory—its volume; whether composed of finished goods; raw material on hand; method of determining the figures, whether estimated or appraised; and how carried, at cost or market values; amount of reserves set up for depreciation purposes.

The accounts receivable need careful attention because the banker looks upon them as a most liquid asset, usually the most capable among the assets of producing the cash quickly. The banker wants to know whether the amounts under this caption are all good, live accounts, what proportion are past due or for any other reason are uncollectible.

An item that is too often overlooked is a firm's contingent liabilities. These may consist of its endorsements on paper discounted, guarantees of accounts, forward contracts for material and any other liability that may be incurred and does not show on the face of the statement.

During the past year shrinkages in values of commodities have occurred that have placed thoroughly solvent concerns in a shaky position because of their inability satisfactorily to adjust contracts which existed before the shrinkage. Such contracts have created contingent liabilities that rise up at the most unexpected times to "smite" the merchant or manufacturer with a most embarrassing demand for payment.

In a very general way I have mentioned items that seem of vital importance to the banker. There may be others that will occur to you. I feel sure that an organization of this kind can be of much benefit in using its influence toward placing the standard for its members so high that the banker or business man will know when he receives a report that it can be accepted without question.

J. P. Morgan said that the first consideration in any demand for credit that he was to consider was the character of the borrower. This must be true of the accountant. You are taken into the confidence and business secrets of the firm engaging you. You are to place before it a report of the business that may be responsible for a course of action which will either make or break the business. The report may be presented to your client's banker as a basis of credit. The client may even suggest to you that you prepare the report so that it will support an application for credit and be passed by a banker. Your position is very much that of a physican who is engaged to keep his patients well. Both the merchant and banker are depending upon your integrity and courage to show any business ill, that it may be corrected at once.

This calls for the highest sense of duty and obligation and means that your organization should not tolerate or condone any breach of the highest ethics.

# The Cost Audit

By Clinton W. Bennett

Many of the difficulties that sometimes arise in obtaining expected results from a well-devised and installed cost system can be traced directly to faulty treating and supervising of the detail records. After the plan has been completely installed and its operation left to the client's force, conditions which are new to the staff are very likely to arise in the handling of the work and consequently important details may be erroneously treated.

Every cost installation should be given close supervision by the cost accountant until he feels that the client's staff can reasonably be expected properly to handle the work. However, regardless of this close supervision during the installation and the conscientious efforts of the client's staff both during the installation and afterwards, errors of principle often develop. Unless promptly detected and rectified these errors of principle may be repeated many times, depending upon the frequency with which the same detail may arise. It is thus apparent that quite serious misstatements may be embodied in the cost results.

As a means of eliminating this condition and assuring maximum results from the cost installation, the cost audit has been developed. It is the province of the cost audit to investigate every operating phase of the cost system. This work should not in any way interfere or dispense with the regular financial auditor. It should supply him with cost details upon which he can place more confidence in preparing his statements of operating results and inventories.

## General Scope

The cost audit generally may be said to cover an examination of the details under the following headings:

- Purchasing
- Stores
- Material cost
- Labor cost
- Burden cost
- Waste and defective work
- Cost summaries
- Cost of production
- Cost of sales
- Monthly executive statements

Some of the more important details found in each of these divisions together with the auditing procedure will be considered in the following discussion:

*Purchasing:*

Care should be taken to insure that the purchasing department shall receive a written requisition for every article purchased, in such form that the order can be placed directly therefrom. Quotation records should be maintained and constantly kept up to date so that requirements may be filled in the quickest and best way.

An examination test of the purchase orders should be made. It is important that all vendor's invoices and goods-received slips be checked against the purchase order. This will serve to verify both prices and quantities.

The method used in following up purchases is an important consideration and the feasibility of graphic purchase control boards should be kept in mind.

*Stores:*

Detailed attention should be devoted to an examination of the methods used in requisitioning materials and to the obtaining of records of deliveries made. The stock-cards or books should be thoroughly examined. A stock record examination is essential whether the material purchase costs are carried on the stock records or not. Enough of the material requisitions and receiving slips and production reports should be checked to the stock records to satisfy the accountant that this important phase of the work is receiving proper attention.

To verify the material costs used, representative invoices should be checked against the stock-cards. No attempt should generally be made to verify all items, for, if representative prices are checked, those remaining can easily be verified merely by comparison. As a means of further checking the clerical accuracy of the records, a certain quantity of the cards should be added and the unit costs verified. The number of cards to check in this way will depend on their quantity as well as the variety of the materials handled. A slide rule will be found of assistance in this work.

After completing the clerical verifications, exhaustive tests should be made of the accuracy of the final results by comparing the balances shown on the stock-cards with the physical inventories and the bin-tags. A record and analysis should be made of any variations so discovered and the variations should be reduced to a percentage basis. This will serve as a means of working towards correct book controls.

The proper balancing of purchases with consumption and quantities on hand is of the utmost importance. Few organizations devote sufficient thought to this important feature. It is not at all unusual to find factories carrying raw materials or partly-finished stock in excess of normal production requirements. As a result capital is unnecessarily tied up and valuable space is occupied solely because of the lack of proper planning.

A good cost system will bring these facts to light. However, it sometimes happens that this is one of the important duties which is neglected after the cost accountant has completed the installation and delegated the operation of the plan to the client's staff. Therefore, the cost audit programme may well place this phase of the investigation among the important steps to be taken.

The physical arrangement of the various store-rooms, the handling of work in process and the stores personnel are matters that should be given thought by the accountant.

*Material Cost:*

It will be necessary to verify the material costs used on the cost summaries. In some industries, materials are purchased for specific orders and the costs are charged directly thereto. Sometimes, the price of one lot of material is applied until the lot is exhausted, when the next oldest lot price will be used. Again, the material cost may represent a unit obtained by averaging the cost of all like materials purchased. The plan will depend on applicability to the particular industry.

Regardless of the method of obtaining the unit material costs, the results shown by the stock records should be checked to the cost summaries to verify the accuracy of the prices used in cost calculating.

Another important matter is accurate material specifications. Whether the conversion basis is weight, count, pound or square feet, correct cost results demand correct units on which to apply the cost price. A careful check of these units should be made. Errors are frequently discovered which are due to faulty weighing of units or incorrect computations.

As the material specifications are not generally as constantly checked as the labor costs, errors in their calculations may have a vital bearing on cost results since the mistake will be multiplied many or few times, depending on the number of varying calculations using this erroneous base.

*Labor Cost:*

The clock in and out cards should be compared with the work reports to an extent sufficient to satisfy the accountant that they are in substantial agreement. The work report cards should be checked against the payroll in sufficient quantities to provide a substantial check on the payroll. The same work reports should be traced to the cost collection records. In this way a direct check is obtained between the operating results and the detail costs. A check should be made on the wage rates, including hourly, piece and bonus rates and efficiencies, etc., by checking the original wage recommendation slips against the labor records, the payroll and the cost collection records. Of course the procedure will vary according to the wage-payment methods in use. Under the straight piece-work plan, this phase of the work will be quite simple, as the piece prices authorized can be traced directly to the cost records. Where straight day-work is in use, records will have to be maintained converting the rate per hour to a definite cost per unit unless the labor is to be charged directly against a specific job order. In either case the details should be verified. If the plant or department operates under the bonus, premium or other kindred wage system, consideration should be given to the original rates, the standard efficiencies, the actual efficiencies, etc., in order definitely to determine the influence each has exercised on costs.

Consideration should be given to a study of the classes of labor treated as indirect. Enough of the indirect reports should be checked to the payroll as well as to the cost collection details to satisfy as to their accuracy. After the labor details have been completely verified, the results should be checked to the cost summary established for each article or representative group of articles produced.

The total cost value of direct labor in work in process as shown by the detail records will then be compared with the labor-in-process control account for the month. The month used may well be the one next preceding the date of the examination. In this way an excellent check on the total labor will be obtained.

*Burden Cost:*

An investigation should be made of the expenses charged to the manufacturing as compared with those charged to the administrative and selling divisions. Errors are frequently made in distinguishing between these two classes of expense.

Next for consideration is the basis of factory burden distribution and the actual division of the expenses between departments or production centers. Thought should then be given to dividing the commercial expenses between the administrative and selling sections of the business. Finally comes a study of the methods used in applying all burden to costs.

*Factory Expense:*

A sufficient quantity of invoices should be checked to the expense records to satisfy as to the accuracy of the latter. All the elements entering into the distribution of the expenses by departments should receive careful scrutiny.

The various distribution bases should be studied. It is often found that much time is used in analyzing and distributing burden to departments upon a basis so incorrect as to make the results of no practical value for cost-accounting purposes. The accountant should devote careful attention to this problem. He will find whether the bases used are fundamentally sound and correctly represent existing facts or not. No phase of cost accounting can be more easily controlled than can the burden and yet no other phase of cost accounting is so frequently incorrectly treated.

With the principles satisfactorily examined, attention should be devoted to making a test of the clerical details of the distributions.

The factory expenses and their distribution to departments or production centers have now been verified. Next the basis of applying these expenses to costs should be considered. While there are several commonly-used methods of applying burden the percentage-on-labor plan will be considered here for purposes of illustration.

It is evident that unless the burden application is properly controlled, correct results will not be obtained regardless of the care used in the distributions. Consequently, the direct labor of each department having a separate burden-rate should be produced monthly. This direct labor should be traced to the payroll. The burden-rates obtained by dividing the burden by the direct labor should be checked. These burden-rates will then be traced to the cost summaries or other point of burden application.

The value of assets on which depreciation is calculated and the rates used should be examined. These asset values should be in substantial agreement with the ledger accounts. Care should be taken to study the collection and distribution of the other fixed charges, such as taxes, insurance and power-plant expense. Serious thought should be given to the methods used in handling returns, repair-shop expense and expenses of a like nature that are sometimes accorded scant attention.

*Commercial Expense:*

A correct split between administrative and selling expense is of vital importance. Any one having experience in industrial concerns can doubtless recall many discussions between the sales and accounting departments regarding charges made to selling of supposedly questionable items from the sales manager's point of view. But of far more importance than the personal satisfaction of any of the individuals involved is the necessity of having these charges made correctly, because of the erroneous executive reports that will flow from mistakes of this character. It is, therefore, advisable to test this phase of the work by tracing a sufficient number of entries back to original invoices.

After analyzing the distributions, representative burden summaries should be tested. The basis used for obtaining the expense percentage—for instance, the cost of sales—should be checked to this burden summary. Next in order is the verification of the final burden-rates. These are then checked to the cost summaries or other burden application point of control.

*Waste and Defective Work:*

Too much emphasis cannot be placed upon the importance of obtaining accurate waste and defective-work records. In every factory this is a vital problem. To say that the annual loss from waste and defective work frequently places the operating results on the wrong side of the ledger would not be far wrong. Losses of this nature are somewhat intangible and more or less apt to be overlooked. An optimistic executive dismisses the thought with the statement that so small are these losses they are not worth considering.

Knowing the importance of the waste and defective-work records, the accountant will investigate each phase of the problem. He will carefully check the waste reports. He will consider the results shown in the light of his experience in like plants elsewhere. The trend of the waste curve will be noted as throwing light on the problem. Any marked tendencies either up or down should be explained by the management. Next the waste rates should be checked to the cost-collection records. The defective-work reports should be examined as a means of discovering the cause of defect and the ratio of defective work to good production. Tests of the costs used in pricing these reports should be made from the cost records. A sufficient test of the clerical computations should also be made. Finally the defective-work total values will be posted to the proper accounts in the works ledger.

*Cost Summaries:*

After completing the details all the cost elements contained on the cost summaries will have been verified. Representative quantities of these summaries should then be examined and added to detect clerical errors. A study of the supporting cost records is essential when they represent standard costs.

In many industries the use of standard costs is of a great deal of assistance in aiding production through intelligent cost accounting. Many times definite cost standards correctly applied unearth and reflect inefficiencies in operating that otherwise would remain hidden.

Unless the standard rates are constantly checked against the actual results, however, very misleading and erroneous conclusions may be formed. The great advantage of the standard cost plan is to have at all times definitely-known basic standards with which to gauge constantly fluctuating actual operating results. With this comparison of actual results against standard rates omitted or half-heartedly carried out the important feature of an excellent cost plan is lost. Gross inaccuracies in cost standards are not unknown and they reflect seriously on the value of the cost system as a whole.

The ultimate use made of the cost results is also a subject worthy of careful analysis. A good cost system should be a valuable aid to the management in efforts to increase production. Obtaining the cost is only one of its functions. Frequently, however, valuable manufacturing data are allowed to remain buried simply because the cost accounting details do not require the use of such information. In their efforts to produce accurate cost results, many corporation accountants lose sight of the importance of statistical records. In many ways the average executive's conception of cost accounting has changed materially in the past few years and progressive industrial managers are increasingly realizing the value of correct, modern, cost-accounting methods.

*Cost of Production:*

The detail production records should be checked to the stock records to verify the proper inclusion in stores of all goods produced. They should also be checked to the production summaries. A sufficient quantity of the cost prices used will be checked from the cost summaries. A test should follow of the clerical computations, additions and extensions. The final total will then be posted to the books.

*Cost of Sales:*

There is need of accurate cost-of-sales figures. When it is remembered that the cost of sales directly affects the profit-and-loss statement and the finished goods inventory, the necessity of obtaining correct results is apparent. A considerable quantity of the units sold will be posted to the cost-of-sales collection sheets. The cost prices should be checked from the cost summaries. Certain of these units sold should also be checked to the finished stores records. The extensions and additions will then be tested and the results will be posted to the financial books.

*Monthly Executive Statements:*

One of the most important duties of the general auditor is a thorough examination of the monthly executive statements. The details and results obtained should be carefully analyzed. A trial balance of the works ledger and private ledger at the date of the examination should be obtained. All balances shown should be checked to the ledgers. This procedure will serve more thoroughly to verify the cost results. Each item shown on the executive statements will be checked to the ledgers. The extensions and footings should be verified.

While this detailed procedure is being carried out by assistants, the accountant will devote considerable study to the executive statements that have been presented previously. The obtaining of reports each month covering the business operations is frequently the factor that decides an executive's mind in favor of a cost system. He wants and ought to expect to be able to have accurate reports presented to him promptly at the end of each month. Having confidence in them, he directs his business ship accordingly. If the reports are incorrect the wrong business course is taken with results serious or trivial, depending on the importance of the expedition. There is a tendency on the part of many bookkeepers entrusted with the preparation of reports to use the results shown by the books and records without a comprehensive analysis to determine whether these results appear relatively reasonable or not. The accountant should therefore be constantly watching for entries of this nature.

## Conclusion

It is, of course, manifestly impossible to prescribe a cost-audit programme that will exactly fit all conditions. Each cost audit contains as many peculiarities as there are differing industries. But, in general, the foregoing procedure has been found of practical application as a working basis in varying industrial organizations.

The cost audit is intended as a direct step towards developing and maintaining sound methods of cost accounting. It serves as a means of protecting the executive against faulty periodical reports. It makes for more efficient results in the cost department, since each operative knows that his work will be audited.

When the investigation is complete, the accountant will present his report setting forth the results of the examination and embodying suggestions for improvement.

# Trial-balance Information

By B. W. Hodges

When monthly profit-and-loss statements are impracticable owing to difficulty of securing trustworthy inventory and gross profit on sales cannot be gauged by past experience, the trial balance frequently contains all the information there is available.

One chief concern of the average executive just now is the financing of his business, and to know the changes in the position of his assets and liabilities is of prime importance. By comparing trial balances and summarizing the changes in accounts, the net result of the month's transactions can be viewed in the perspective and changes in position readily noted.

The executive can usually grasp this information much easier if it is placed in a receipts and disbursements form. The following exhibits will illustrate this point.

EXHIBIT A

COMPARATIVE TRIAL BALANCE

| Debits | Feb. | Jan. | (+) Increase (—) Decrease |
|---|---|---|---|
| Cash | $5,000 | $6,500 | —$1,500 |
| Notes and accounts receivable | 35,000 | 30,000 | + 5,000 |
| Fixed assets | 55,000 | 54,000 | + 1,000 |
| Purchases and inventory | 60,000 | 50,000 | +10,000 |
| Selling expense | 2,500 | 2,000 | + 500 |
| Administrative expense | 1,500 | 1,100 | + 400 |
| Insurance | 800 | 700 | + 100 |
| Interest | 900 | 850 | + 50 |
| | 160,700 | 145,150 | +15,550 |
| **Credits** | | | |
| Notes and accounts payable | 25,000 | 16,650 | + 8,350 |
| Sales | 55,000 | 47,500 | + 7,500 |
| Capital stock | 50,000 | 50,000 | |
| Surplus | 30,700 | 31,000 | — 300 |
| | 160,700 | 145,150 | +15,550 |

SUMMARY OF CHANGES IN ACCOUNTS

| Net Increase in Values Received | | |
|---|---|---|
| Increased notes and accounts payable | $8,350 | |
| Reduced bank balances | 1,500 | $9,850 |

| | | | |
|---|---|---|---|
| DISPOSITION | | | |
| Increased notes and accounts receivable | | 5,000 | |
| Increased fixed assets | | 1,000 | |
| Purchases increase | $10,000 | | |
| Less sales increase | 7,500 | | |
| Net merchandise increase | | 2,500 | |
| Selling expense for month | | 500 | |
| Administrative expense for month | | 400 | |
| Insurance paid for month | | 100 | |
| Interest for month | | 50 | |
| Paid income tax (surplus reduced) | | 300 | 9,850 |

## EXHIBIT B

### COMPARATIVE TRIAL BALANCE

| | Mar. | Feb. | (+) Increase (—) Decrease |
|---|---|---|---|
| DEBITS | | | |
| Cash | $5,250 | $5,000 | + $250 |
| Notes and accounts receivable | 29,000 | 35,000 | — 6,000 |
| Fixed assets | 55,000 | 55,000 | |
| Purchases and inventory | 65,000 | 60,000 | + 5,000 |
| Selling expense | 2,950 | 2,500 | + 450 |
| Administrative expense | 1,875 | 1,500 | + 375 |
| Insurance | 825 | 800 | + 25 |
| Interest | 950 | 900 | + 50 |
| | 160,850 | 160,700 | + 150 |
| CREDITS | | | |
| Notes and accounts payable | 19,150 | 25,000 | — 5,850 |
| Sales | 61,000 | 55,000 | + 6,000 |
| Capital stock | 50,000 | 50,000 | |
| Surplus | 30,700 | 30,700 | |
| | 160,850 | 160,700 | + 150 |

### SUMMARY OF CHANGES IN ACCOUNTS

| | | | |
|---|---|---|---|
| NET INCREASE OF VALUES RECEIVED | | | |
| Sales increase | $6,000 | | |
| Less purchases increase | 5,000 | | |
| Net receipts from merchandise | | $1,000 | |
| Notes and accounts received reduced | | 6,000 | $7,000 |
| DISPOSITION | | | |
| Reduced notes and accounts payable | | 5,850 | |
| Increased bank balances | | 250 | |
| Selling expense for month | | 450 | |
| Administrative expense for month | | 375 | |
| Insurance paid | | 25 | |
| Interest paid | | 50 | 7,000 |

It will be noted from exhibit A that the business is expanding; that the money received from increased current obligations is being tied up in fixed assets and expenses (a dangerous practice), whereas the following month exhibit B shows liquidation and a healthier aspect. While the above figures give no indication of profits or losses, except such as might be judged from the volume of business, they do show the shifting of values, which is interesting and important information.

If the number of accounts carried is large, they can be classified and shown on supporting schedules, only the totals of each class appearing on the comparative trial balance and summary.

In making up the summary it should be remembered that the positive debit balances plus negative credit balances equal positive credit balances plus negative debit balances.

*The* JOURNAL *of* ACCOUNTANCY
*Official Organ of the* AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

# EDITORIAL

## Admission Requirements of the American Institute

When the American Institute of Accountants was formed in 1916, one of its fundamental principles was the requirement that all persons admitted to the Institute after the original charter members had been admitted should come in only by way of the Institute's own examinations. The need for some regulation of the profession by the profession was manifest to all, and it would have been futile to attempt to build a strong organization based upon material so variable as that produced by an utterly unstandardized series of state examinations.

Everyone recognized that the Institute was an experiment, and there were some who had doubts as to the possibility of establishing a strong organization with admissions so restricted as would necessarily be the case in a society limiting its members to those who had passed high technical examinations. The experiment, however, was a success much greater than even its most hopeful sponsors had expected, and it is noteworthy that with the exception of a decreased ratio of additions during the period of the war, the numbers of members have increased more rapidly year by year.

One of the unexpected developments following the formation of the Institute was the adoption of the Institute's examinations by a number of the states, with the result that in a majority at least of the states there was a standard of examination and a fairly rigid adherence to a standard in the grading of candidates' papers. Following this development, the question occurred to the board of examiners of the Institute and to many other members of the Institute, whether or not it might be possible to extend a certain amount of recognition to certificates issued in states in which the requirements were generally satisfactory even if such states did not feel themselves in a position to enter into the plan of coöperation with the Institute. This question with others was discussed at a series of meetings of members of the Institute held throughout the country during the past winter. The matter was brought before the council of the Institute at the meeting of April 10, 1922, and, after deliberation, the thought was expressed that it might be well for the board of examiners to consider the possible desirability of giving recognition in certain cases to the results of examinations conducted outside the plan of coöperation.

The board of examiners, pursuant to the council's suggestion, considered the matter and adopted a new rule which we believe will be of interest to nearly all the readers of this magazine. The following paragraphs are quoted verbatim from the amended rules of the board:

OTHER EXAMINATIONS

Until further notice, the board of examiners in its discretion exercised in the case of any individual applicant for admission to the Institute may accept in lieu of its own examinations a certificate as a certified public accountant of any state of the United States, the laws of which are held by the board of examiners of the Institute to be adequate and well administered, or a certificate of membership in a society of professional accountants in a foreign country whose requirements for admission are considered by the board of examiners of the Institute equivalent to the Institute's examinations, provided that such applicant shall have received such certificate as certified public accountant or member of a society of professional accountants after adequate examination and that he shall have been in practice as a public accountant or in the employ on the accounting staff of a public accountant for a period of two years next preceding the date of his application, and provided further that he shall be recommended for admission by three members of the Institute residing near the place of residence of the applicant, such members to be selected by the board of examiners without knowledge of the applicant and to report to the board of examiners upon the applicant's professional qualifications, character and reputation.

In the case of an applicant conforming to all the provisions contained in the foregoing paragraph and presenting evidence of five years' public practice immediately preceding the date of his application or ten years' public practice, one year of which shall have immediately preceded date of application, the board of examiners may require such applicant to submit a thesis upon one of a group of subjects to be designated by the board and upon the result of such thesis may recommend the applicant for admission as member of the American Institute of Accountants. The board, however, may accept other evidence of professional qualifications in lieu of a thesis.

There are several features in the foregoing rule which are worthy of special notice.

In the first place, the rule is applicable "until further notice." Consequently, it may be inferred that the board does not intend that such recognition shall be continued indefinitely.

The requirement of an examination of an applicant's qualifications by members of the Institute investigating and reporting without the knowledge of the applicant bears a striking similarity to the restrictions placed upon admission to various fraternal organizations. It should not operate to preclude the admission of any desirable applicant, but it may be expected to render extremely unlikely the admission of unworthy persons.

It is well, in reviewing these amended rules of the board of examiners, to draw attention again to the provision for oral examinations which has existed since the board of examiners began its functions. Oral examination is intended to provide a means of entrance for accountants who are more familiar with the actual work of the profession than with the theory which is so largely and necessarily a part of written examinations. Let us quote from the syllabus prepared by the board the following description of the oral examinations and requirements.

EXAMINATIONS—ORAL

Under the provisions of the constitution the board of examiners is permitted to require candidates to pass written or oral or partly written and partly oral examinations.

The rules of the board of examiners provide that persons who are over 30 years of age or are certified public accountants or possessors of equivalent foreign degrees approved by the board of examiners may be subjected to oral instead of written examination, provided such applicants present evidence of having been in public practice for seven years or in practice on their own account for five years.

Oral examinations are technical in character and are designed to demonstrate the applicant's practical knowledge of accounting. The questions are based upon the questions of the written examinations, but an effort is made to permit practitioners who have been in practice for many years to explain their treatment of principles and cases involved in a somewhat more informal way than would be possible in a written examination.

Each candidate is examined separately, and the transcript of all questions and answers is presented to the entire board for consideration.

Oral examinations under the rules of the board of examiners must be conducted by members of the board of examiners. Such examinations are usually held in the principal centers of accounting activity, such as Boston, New York, Chicago and San Francisco, but special sessions may be held elsewhere in the discretion of the board of examiners.

By means of the provisions which have been quoted, it should be possible for every eligible and desirable accountant of either sex to obtain admission to the national body of professional accountants. Naturally there must be clear evidence that the applicant is a fit and proper person to present himself or herself to the public as a practitioner, and in order to demonstrate that fitness there must be examination. It cannot be said, however, that the restrictions are narrow, nor can it be shown that they are unnecessarily severe. They demonstrate the Institute's desire to admit to its membership all who are justly entitled to the honor; and we believe that when these facts are duly considered there will be a considerable number of applicants who will seek admission under the comprehensive interpretation which the board gives to the provisions of the constitution of the Institute.

The board makes it known that it will welcome applications from all who are eligible, and it urges upon the profession as a whole the consideration of the benefits to be derived by every practitioner from united effort in the cause of better accountancy which the Institute has served so effectively in recent years.

The board of examiners has prepared for distribution a new edition of its circular of information and syllabus containing all the amendments and additions now in force. Copies of this circular may be obtained from the office of the Institute in New York.

## Audit Working Papers

The endowment fund of the American Institute of Accountants is about to announce for publication in the fall a practical text-book on audit working papers which is now being prepared by J. Hugh Jackson. Mr. Jackson was formerly assistant professor of accounting at Harvard and is now associated with Price, Waterhouse & Co. This firm has agreed to donate to the endowment fund the copyright of the forthcoming book without cost for the preparation of the material. The net proceeds of sales will accrue wholly to the endowment fund.

The book is to be illustrated with photographed schedules in considerable numbers, and will contain an explanatory text which should make it of the utmost service both for practical purposes and as a college text-book.

Further details of the publication will doubtless appear in subsequent issues of this magazine.

# Income-tax Department

EDITED BY STEPHEN G. RUSK

Our attention has been directed to a report made to the New York County Lawyers' Association by its committee on the unlawful practice of law, wherein are set forth examples of the evils arising from the performance of legal work by those unqualified and incompetent in matters of law. The investigation of this committee disclosed among other things that in advising upon and in the preparation of income-tax returns the line between the work devolving upon the lawyer and that upon the accountant is difficult to draw. The committee is of the opinion that the accountant is not competent to advise a taxpayer upon such matters as "the domicile of citizens, the effect of increasing or decreasing corporate stock, the advantage of trading in corporate or in individual and partnership form." It regards such questions as intricate and complicated questions of law. Its conclusions are quoted as follows:

> "Patently advice along these matters requires the services of a skilled and experienced lawyer; nevertheless the preparation of income-tax returns and accounting work in themselves are primarily the work of a skilled accountant."

A further conclusion of this committee is that:

> "There can be no question that where a lawyer divides fees with a firm of accountants for procuring of legal business arising originally out of employment solicited for the accountant in connection with income-tax matters, or where the layman performs purely legal services for which he is not qualified, a violation of law exists."

We imagine that no fault will be found by accountants with the general proposition that their profession does not qualify them to give advice upon legal matters. There are accountants, we must admit, who have not hesitated to advise their clients upon questions that it would have been better to leave to the lawyer, but these instances are rare. However, instances where lawyers have sought to make income-tax returns when intricate and complex accountancy was involved (and this to the detriment of the interests of the clients) are numerous. The proportion of lawyers qualified to advise upon income-tax matters and to prepare income-tax returns apparently is not large and numerous instances could be cited wherein great harm has been done by lawyers in attempting to solve problems for which they were not qualified.

With the conclusion of this committee as to dividing fees we can find no fault, but we do not wholly agree that the accountant's work should be confined in the small limits set for it by the committee. "The preparation of income-tax returns" necessitates familiarity with the income-tax law, the regulations promulgated for its interpretation and the large body of decisions (court, solicitor's and office) that are continually being made. Surely the accountant does not violate the law when he counsels with his client concerning matters with which he must be familiar.

The committee reports that the federal government has sanctioned the practice permitting laymen, whom it describes as "clerks in department stores and banks and others," to assist in the "filling out and preparation of income-tax blanks." It did not report that the federal government also sanctions the appearance before its tribunal of "agents" for the taxpayer, with the view to facilitating the proper application of the law.

It is fortunate for the taxpayer that the federal government has found no difficulty in making distinctions and we feel that some one should inform the lawyers' committee of the large and important part members of the American Institute of Accountants took in the preparation of the several revenue acts and of the regulations and of the assistance they have given in preparing opinions that have been contained in the treasury and other decisions based on these acts. We believe the committee should also send for the regulations of the treasury department wherein are set forth rules that are to govern those who are admitted to practise as attorneys or agents before the department. It will then see among other things that the advertising attorney or accountant is barred from appearing in his capacity as attorney or agent before the department, which should prove that the treasury department is jealously distinguishing between those genuinely qualified and those who are not.

* * * *

Among the decisions handed down recently one that is of outstanding interest is No. 3333 which sets forth "ratios of postwar costs of replacement for use in preparation of claims for amortization." The department points out in the decision that the purpose of these ratios is to facilitate the preparation and examination of claims and to bring about uniformity as to basis for claims." The allowances based on these ratios it must be understood are purely tentative and are subject to redetermination in accordance with the provisions of the law.

## TREASURY RULINGS

(T. D. 3329—May 13, 1922)

*Income tax—Priority of consideration*

Expeditious disposition of tax cases in which an emergency has been found to exist.

If, upon application of any taxpayer, it be shown to the satisfaction of the commissioner (1) that the taxpayer is in the hands of a receiver and a reorganization is necessary; (2) that the taxpayer is in financial difficulties, either actual or imminent, and refinancing is necessary; or, (3) that the distribution of a fund in which a large number of people may be interested is held up pending the determination of the amount of income or profit taxes which must be paid out of the fund—then the commissioner will declare an emergency to exist with reference to such case and will direct that the matter be given priority of consideration with a view to the expeditious determination of the particular tax liability.

Application for such priority of consideration shall be in the form of a letter addressed to the commissioner and shall be supported by statements under oath setting forth in detail the facts upon which the request for special consideration is based, and the particular reason why such person believes himself entitled to have the case expedited as provided herein.

(T. D. 3330—May 13, 1922)

*Income tax—Revenue act of 1918—Decision of court.*

1. INCOME TAX—DEDUCTION—WISCONSIN SOLDIERS' BONUS TAX.

The plaintiff was a corporation, keeping its accounts and filing returns upon an accrual basis, and annually set up upon its books a "reserve" for income taxes due the state of Wisconsin, under the laws of which it was organized. Under the provisions of section 234 (a) (3), revenue act of 1918, the company deducted from its federal income-tax return for the year 1918 the "reserve" for income taxes due the state at the rate in effect on December 31, 1918. On July 30, 1919, the Wisconsin legislature passed a "soldiers' bonus" act, which provided for the raising of the money by a single tax levy of one mill on all assessed property for the year 1919, and a surtax over the normal tax on the incomes of corporations upon the basis of the 1918 state income-tax returns. After the ratification of the soldiers' bonus act on October 10, 1919, the plaintiff filed an amended federal income-tax return for the year 1918 and sought to deduct therein as taxes accrued for the year 1918 the amount of additional taxes due the state under the soldiers' bonus act. *Held*, that the basis of the levy of the soldiers' bonus tax was 1918 incomes, but there is no relation between the basis for the state levy and the time of the accrual of the tax for federal tax purposes.

2. DEDUCTION—STATE TAXES—"ACCRUED" WITHIN THE YEAR—SECTION 234 (a) (3), REVENUE ACT 1918.

A tax does not "accrue" until it becomes a liability of the taxpayer, and a tax can not be "accrued" and deducted for federal income-tax purposes in the year 1918 where the state act creating the tax liability was not passed until the year 1919.

The appended decision of the United States Circuit Court of Appeals for the seventh circuit, affirming the judgment of the United States District Court for the western district of Wisconsin in the case of Ed. Schuster & Co. (Inc.), v. Williams, collector, is published for the information of internal-revenue officers and others concerned.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT. No. 3039. OCTOBER TERM, 1921. JANUARY SESSION, 1922.

*Ed. Schuster & Co. (Inc.), plaintiff in error, v. Burt Williams, as collector of the United States internal revenue for the district of Wisconsin, defendant in error.*

ERROR to the district court of the United States for the western district of Wisconsin.

Before BAKER, ALSCHULER, and EVANS, circuit judges.

Opinion by ALSCHULER, judge:

Plaintiff in error, a Wisconsin corporation, with principal office at Milwaukee, duly made its return for the federal income tax for the year ending December 31, 1918. The return was on the "accrual" basis, and one of the deductions was of the income tax of the state of Wisconsin, at the rate in effect December 31, 1918.

July 30, 1919, the Wisconsin legislature passed a "soldiers' bonus" act, which provided for the raising of the entire bonus by one tax levy of 1 mill on all assessed property for the year 1919 and a surtax over the normal tax upon the incomes of corporations, upon the basis of Wisconsin income-tax return for the calendar year 1918. (Wis. Laws, 1919, ch. 667.) The act by its terms did not become effective until ratification by a popular vote, which occurred October 10, 1919. The soldiers' bonus tax which this corporation was required to pay on the basis of the 1918 return for state income tax was not, and in the nature of things could not have been, included in its deduction of "reserve for taxes" in its federal income-tax return for 1918, which it made in June, 1919. But upon the favorable vote on the act the corporation filed an amended income-tax return for the year 1918, wherein its soldiers' bonus tax, payable on the basis of the Wisconsin income-tax return, was additionally included in the deduction of "reserve for taxes" in its 1918 federal income-tax return, by which further deduction its federal income tax due the United States for the year 1918 would be reduced by nearly $10,000 below the tax as originally returned. Corresponding abatement from the tax as first returned was duly demanded, and the claim therefor duly rejected on the ground that the soldiers' bonus tax did not accrue in 1918 and could not be included in reserve for taxes for that year, but that the deduction must be made from profits and income for the year 1919. The higher federal income-tax rate for 1918, and perhaps larger income for that year, made it advantageous to the taxpayer to take the deduction from the 1918 profits rather than from those of 1919.

The federal income-tax law provides:

Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: * * *

(3) Taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits and excess-profits taxes; or (b) by the authority of any of its possessions, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 238; or (c) by the authority of any state or territory, or any county, school district, municipality or other taxing subdivision of any state or territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed.

The only question is whether the Wisconsin soldiers' bonus tax of 1919 accrued in 1918 so as to be deductible from the gross corporate income for 1918.

The bonus act provided that the bonus fund be raised by a single levy of a 1-mill tax on all property, and a stated surtax on all corporate incomes as returned to the state for the year 1918. It is not contended that the 1-mill property tax accrued in 1918. But would this have been any more a tax accrued in 1918 had the act provided that the basis of its levy should be the property assessment for 1918? We think not. It was none the less a tax accruing in 1919, whether the basis of levy was the assessment of 1918 or of some earlier year.

There is no necessary relation between the basis for the levy and the time of the accrual of the tax. Whether computed on a property assessment or a state income-tax return, the tax did not accrue until it became a liability of the taxpayer. Since the act creating the tax was not passed until after the federal income-tax year of 1918, this soldiers' bonus tax can in no sense be deemed to have accrued during the calendar year prior to that of its passage.—*United States v. Woodward et al.* (June 6, 1921, 256 U. S. 632.)

This tax, not accruing in 1918, is not a proper item of deduction for that year, and the district court correctly sustained the demurrer to the declaration filed in this suit to recover the paid tax from the collector of internal revenue.

The judgment is affirmed.

(T. D. 3333—May 19, 1922)

*Ratios of estimated postwar costs of replacement for use in preparation of claims for amortization.*

Pursuant to article 184 of regulations No. 62, the commissioner has determined and publishes the following ratios of estimated postwar cost of replacement for use by taxpayers in computing claims for tentative allowance for amortization.

The purpose of establishing these ratios is to facilitate the preparation and examination of claims and to bring about, to such extent as may be practicable, uniformity as to the basis of claims. The allowances based thereon will be purely tentative and subject to redetermination in accordance with the provisions of the law.

These ratios, condensed as they are to cover 16 groups, are necessarily composite figures, arrived at by an examination of many items entering into the respective groups, and it is realized that in some cases where only a limited number of items in the group are involved, the ratios given may not fairly be applicable to a particular case. In such cases the claim for amortization should be made in accordance with the ratios published, but the taxpayer, along with his claim, should submit a statement showing in detail the reasons why, and the extent to which, such ratio is not properly applicable to his claim, so that such cases may receive special consideration; in like manner, there may be cases where the ratios as applied to the particular claim would give the taxpayer more than a reasonable allowance, and in such cases the ratio properly applicable will be determined on the examination of the claim and the taxpayer given notice thereof.

All ratios are expressed in percentages based on prices as of June 30, 1916.

A. Ratios for computing estimated postwar cost of replacement of buildings, vessels, cars, tanks, blast furnaces, open-hearth furnaces, annealing furnaces, electric furnaces, coke ovens and construction of all kinds:

| | Per cent. |
|---|---|
| 1. Lumber— | |
| (a) Hard | 240 |
| (b) Soft | 175 |
| 2. Structural steel | 60 |
| 3. Building materials, other than lumber and structural steel | 225 |
| 4. Steel (other than structural steel) and steel products | 90 |
| 5. Building equipment | 150 |
| 6. Labor (all classes) | 160 |

B. Ratios for computing estimated postwar costs of replacement of machinery and equipment:

| | Per cent. |
|---|---|
| 7. Electrical machinery and equipment | 130 |
| 8. Engines, turbines, compressors and similar facilities | 175 |
| 9. Pumps | 135 |
| 10. Boilers | 160 |
| 11. Transmission equipment— | |
| (a) Shafting, pulley, hangers, etc. | 135 |
| (b) Belting | 100 |
| 12. Machine tools and small tools (machine tools are considered as that class of metal working machinery which can be used on both cast iron and steel) | 130 |
| 13. Wood-working machinery | 155 |
| 14. Textile machinery | 155 |
| 15. All other machinery (including cranes)— | |
| (a) Machinery, the cost of which did not exceed 10 cents per pound as of June 30, 1916 | 120 |
| (b) Machinery, the cost of which did exceed 10 cents per pound as of June 30, 1916 | 130 |
| 16. Office furniture and equipment | 125 |

# Students' Department

EDITED BY H. A. FINNEY

## INSTITUTE EXAMINATIONS

[NOTE—The fact that these solutions appear in THE JOURNAL OF ACCOUNTANCY should not lead the reader to assume that they are the official solutions of the American Institute of Accountants. They merely represent the personal opinion of the editor of the *Students' Department*.]

## AMERICAN INSTITUTE OF ACCOUNTANTS

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART I

May 18, 1922, 1 P.M. to 6 P.M.

*The candidate must answer the first four questions and one other question.*

No. 1 (30 points):

A, B, C and D have been in partnership for three years, but, a misunderstanding having arisen, negotiations are in progress with intent to induce D to withdraw. The articles of partnership provide that the partners shall not be allowed any salaries but shall be permitted to make cash drawings of $175.00 monthly. These amounts were drawn the first year. Then, by mutual consent, the drawings were increased the second year to $200.00 each and the third year to $225.00 each.

You are called upon to determine the amount to which D will be entitled if he decides to withdraw; and, in your examination of the books, you find the following facts which have not previously been brought to the attention of the partners.

The bookkeeper has charged the drawings to profit-and-loss, has not provided reserves for depreciation or bad debts; and it is now agreed that proper adjustment shall be made of these particular items.

An analysis discloses the following facts with regard to bad debt losses:

| | First year | Second year | Third year | Total |
|---|---|---|---|---|
| Losses charged off as ascertained ..... | $139.50 | $378.60 | $489.75 | $1,007.85 |
| Reserve which should be set up at the present time .................... | | | | 615.85 |
| Losses which arose from sales in various years .................... | 523.60 | 436.95 | 663.15 | 1,623.70 |

Annual depreciation is agreed upon at the rate of 5% of the cost of the buildings and at the rate of 10% of the cost of the furniture and fixtures, which have appeared on the books with the following balances:

| | Buildings | Furniture and fixtures |
|---|---|---|
| Beginning of first year ................ | $5,400.00 | $ 950.00 |
| Beginning of second year ............ | 5,950.00 | 1,075.00 |
| Beginning of third year ............... | 6,200.00 | 1,215.00 |

The profits as ascertained have been credited to the partners' capital accounts in the agreed profit-and-loss ratios, and no other entries have been made in these accounts.

The following is an abstract of the capitals:

| | A | B | C | D |
|---|---|---|---|---|
| Capitals, beginning of first year .. | $ 5,000.00 | $ 8,000.00 | $12,000.00 | $15,000.00 |
| Profits, first year ............... | 486.00 | 972.00 | 1,458.00 | 1,944.00 |
| Capitals, beginning of second year. | $ 5,486.00 | $ 8,972.00 | $13,458.00 | $16,944.00 |
| Profits, second year ............ | 685.20 | 1,142.00 | 1,827.20 | 2,055.60 |
| Capitals, beginning of third year .. | $ 6,171.20 | $10,114.00 | $15,285.20 | $18,999.60 |
| Profits, third year .............. | 822.25 | 1,391.50 | 2,087.25 | 2,024.00 |
| Capitals, end of third year ...... | $ 6,993.45 | $11,505.50 | $17,372.45 | $21,023.60 |

The partnership articles provide that in the event of the withdrawal of any partner by mutual consent at the end of any year, the goodwill of the partnership shall be valued at 1½ years' purchase of the profits of the last year in excess of 6% of the total capital at the beginning of that year.

Show what amount D will be entitled to receive if he withdraws.

*Solution:* The first step is to adjust the profits and determine the true amounts which should be credited to D. This necessitates ascertaining what per cent. of the profits has been credited to D each year.

| | D's share of profits | | Total profits | | D's per cent. |
|---|---|---|---|---|---|
| First year .................. | $1,944.00 | ÷ | $4,860.00 | = | 40% |
| Second year ................ | 2,055.60 | ÷ | 5,710.00 | = | 36% |
| Third year .................. | 2,024.00 | ÷ | 6,325.00 | = | 32% |

The adjustment of the profits involves:

(a) Adding back the drawings, which should not have been treated as an expense, since the articles specifically state that salaries are not to be allowed.

(b) Adding back bad debt losses charged off and deducting true bad debt losses by years. This is essential because the profit-and-loss ratio has varied from year to year, and because the goodwill is to be based on the third year's profits.

(c) Providing depreciation on the buildings and the furniture and fixtures.

STATEMENT TO DETERMINE TRUE PROFITS AND D'S SHARE THEREOF — *Exhibit A*

| | First yr. | Second yr. | Third yr. |
|---|---|---|---|
| Profits, as stated in problem ........... | $ 4,860.00 | $ 5,710.00 | $ 6,325.00 |
| Add back drawings, improperly charged to profit and loss: | | | |
| First year: $175.00 × 12 × 4....... | 8,400.00 | ....... | ....... |
| Second year: 200.00 × 12 × 4....... | ....... | 9,600.00 | ....... |
| Third year: 225.00 × 12 × 4....... | ....... | ....... | 10,800.00 |
| Add back bad debts charged off ....... | 139.50 | 378.60 | 489.75 |
| Total ................................ | $13,399.50 | $15,688.60 | $17,614.75 |
| Deduct: | | | |
| True bad debt losses by years .......... | $ 523.60 | $ 436.95 | $ 663.15 |
| Depreciation of buildings: | | | |
| First year: 5% of $5,400.00........ | 270.00 | ....... | ....... |
| Second year: 5% of 5,950.00........ | ....... | 297.50 | ....... |
| Third year: 5% of 6,200.00........ | ....... | ....... | 310.00 |
| Depreciation of furniture and fixtures: | | | |
| First year: 10% of $ 950.00...... | 95.00 | ....... | ....... |
| Second year: 10% of 1,075.00...... | ....... | 107.50 | ....... |
| Third year: 10% of 1,215.00...... | ....... | ....... | 121.50 |
| Total deductions ..................... | $ 888.60 | $ 841.95 | $ 1,094.65 |
| True profits ......................... | $12,510.90 | $14,846.65 | $16,520.10 |

D's Share of Profits

| | | |
|---|---|---|
| First year: | 40% of $12,510.90 | $ 5,004.36 |
| Second year: | 36% of 14,846.65 | 5,344.79 |
| Third year: | 32% of 16,520.10 | 5,286.43 |
| Total | | $15,635.58 |

Computation of Goodwill — *Exhibit B*

| | | | |
|---|---|---|---|
| Profits of the third year (exhibit A) .. | ....... | ....... | $16,520.10 |
| Less 6% interest on capital at beginning of third year: | | | |
| Capital invested—beginning of first year: | | | |
| A | $ 5,000.00 | ....... | ....... |
| B | 8,000.00 | ....... | ....... |
| C | 12,000.00 | ....... | ....... |
| D | 15,000.00 | $40,000.00 | ....... |
| Add profits of first two years (exhibit A): | | | |
| First year | $12,510.90 | | |
| Second year | 14,846.65 | 27,357.55 | |
| Total | ....... | ....... | 67,357.55 |
| Deduct drawings of first two years: | | | |
| First year | $ 8,400.00 | ....... | ....... |
| Second year | 9,600.00 | 18,000.00 | ....... |
| Capital, beginning of third year .... | ....... | ....... | $49,357.55 |
| 6% interest thereon | ....... | ....... | 2,961.45 |
| Profits of third year in excess of 6% interest on capital at the beginning of the third year | | | 13,558.65 |
| Multiply by | | | 1½ |
| Goodwill | | | $20,337.98 |
| D's share: 32% thereof | | | $ 6,508.15 |

Goodwill should be divided among partners in the profit-and-loss ratio of the year when the division is made.

Statement of Amount Due to D — *Exhibit C*
(In event of withdrawal)

| | | |
|---|---|---|
| Original investment | | $15,000.00 |
| Add profits for three years (exhibit A) | | 15,635.58 |
| Add goodwill (exhibit B) | | 6,508.15 |
| Total | | $37,143.73 |
| Deduct drawings: | | |
| First year | $ 2,100.00 | |
| Second year | 2,400.00 | |
| Third year | 2,700.00 | 7,200.00 |
| Balance due D if he withdraws | | $29,943.73 |

No. 2 (27 points):

You are called upon to prepare an adjusted statement of the surplus of the Washburn Manufacturing Company at December 31, 1918, and of the profits for 1919, 1920 and 1921.

The surplus account on the company's books appears as follows:

SURPLUS

| | | | |
|---|---|---|---|
| Dividends, 1919 ....... | $ 40,000.00 | Balance, Dec. 31, 1918.. | $235,000.00 |
| " 1920 ....... | 35,000.00 | Profits, 1919 .......... | 65,000.00 |
| " 1921 ....... | 20,000.00 | " 1920 .......... | 78,300.00 |
| Balance, Dec. 31, 1921.. | 331,300.00 | " 1921 .......... | 48,000.00 |
| | $426,300.00 | | $426,300.00 |

The company has not provided for accruals and deferred items in closing its books and has ignored the following items at the various dates of closing:

| | Deferred charges | Deferred income | Accrued expenses | Accrued income |
|---|---|---|---|---|
| December 31, 1918 ....... | $2,125.00 | ........ | $5,200.00 | $ 475.00 |
| " 31, 1919 ....... | 2,640.00 | ........ | 3,135.00 | ........ |
| " 31, 1920 ....... | 3,100.00 | $1,250.00 | 6,120.00 | 290.00 |
| " 31, 1921 ....... | 1,950.00 | 700.00 | 4,200.00 | ........ |

In closing the books the inventories were priced at cost or market, whichever was lower, and, in addition, reserves for possible future declines in market value were set up as follows:

| | |
|---|---|
| At December 31, 1919 ...................... | $ 8,000.00 |
| " " 31, 1920 ...................... | 12,600.00 |
| " " 31, 1921 ...................... | 9,250.00 |

Each reserve was set up by a charge to profit-and-loss and remained on the books until the next closing, when it was credited to the account with the opening inventory. The reserve set up at the end of 1921 is still on the books.

Consigned goods have been included in the inventories at billed price. The company has billed all goods sent to consignees at 130% of cost. The following consigned goods inventories have been included:

| | |
|---|---|
| At December 31, 1919 ...................... | $15,600.00 |
| " " 31, 1920 ...................... | 10,400.00 |
| " " 31, 1921 ...................... | 18,200.00 |

Prepare a corrected statement of the surplus account from December 31, 1918, to December 31, 1921.

*Solution:* The following statement of adjustments is self-explanatory, with the possible exception of the treatment of the reserve for inventory fluctuations. By valuing the inventories at the lower of cost or market at the end of each year, the company took up each year the loss on market declines accruing during the year. By charging profit-and-loss with an additional provision for future possible losses, the company anticipated the losses. This is a conservative thing to do, but the provision should be made from surplus, because the loss is not certain to occur, the amount is an estimate, and if it does occur it should be charged to profit-and-loss in the period when it does occur. The reserve should be provided from surplus, and the reserve set up at the end of one year should be returned to surplus during or at the close of the next year. So far as the profit-and-loss account is concerned, the inventories are valued at cost or market, whichever is lower, at the date of the closing.

THE WASHBURN MANUFACTURING COMPANY

STATEMENT OF SURPLUS AND PROFIT-AND-LOSS ADJUSTMENTS

December 31, 1918, to December 31, 1921

| | | Surplus Dec. 31, 1918 | | Profit-and-loss 1919 | | Profit-and-loss 1920 | | Profit-and-loss 1921 | |
|---|---|---|---|---|---|---|---|---|---|
| Balances—per books | | | $235,000 | | $65,000 | | $78,300 | | $48,000 |
| Deferred charges: | | | | | | | | | |
| Dec. 31, 1918 | | | 2,125 | $2,125 | | | | | |
| " 31, 1919 | | | | | 2,640 | $2,640 | | | |
| " 31, 1920 | | | | | | | 3,100 | $3,100 | |
| " 31, 1921 | | | | | | | | | 1,950 |
| Deferred income: | | | | | | | | | |
| Dec. 31, 1920 | | | | | | 1,250 | | | 1,250 |
| " 31, 1921 | | | | | | | | 700 | |
| Accrued expenses: | | | | | | | | | |
| Dec. 31, 1918 | | $5,200 | | | 5,200 | | | | |
| " 31, 1919 | | | | 3,135 | | | 3,135 | | |
| " 31, 1920 | | | | | | 6,120 | | | 6,120 |
| " 31, 1921 | | | | | | | | 4,200 | |
| Accrued income: | | | | | | | | | |
| Dec. 31, 1918 | | | 475 | 475 | | | | | |
| " 31, 1920 | | | | | | | 290 | 290 | |
| Reserve for inventory fluctuation: | | | | | | | | | |
| Dec. 31, 1919 | | | | | 8,000 | 8,000 | | | |
| " 31, 1920 | | | | | | | 12,600 | 12,600 | |
| " 31, 1921 | | | | | | | | | 9,250 |
| Profit on consigned goods inventories: | | | | | | | | | |
| Dec. 31, 1919: Billed | $15,600 | | | | | | | | |
| Cost | 12,000 | | | 3,600 | | | 3,600 | | |
| " 31, 1920: Billed | 10,400 | | | | | | | | |
| Cost | 8,000 | | | | | 2,400 | | | 2,400 |
| " 31, 1921: Billed | 18,200 | | | | | | | | |
| Cost | 14,000 | | | | | | | 4,200 | |
| Adjusted balances | | 232,400 | | 71,505 | | 80,615 | | 43,880 | |
| | | $237,600 | $237,600 | $80,840 | $80,840 | $101,025 | $101,025 | $68,970 | $68,970 |

THE WASHBURN MANUFACTURING COMPANY
ADJUSTED STATEMENT OF SURPLUS ACCOUNT
December 31, 1918, to December 31, 1921

| | | |
|---|---|---|
| Surplus, December 31, 1918 | | $232,400.00 |
| Add profits: 1919 | | 71,505.00 |
| Total | | 303,905.00 |
| Deduct: dividends | $ 40,000.00 | |
| Provision for possible inventory losses | 8,000.00 | 48,000.00 |
| Surplus, December 31, 1919 | | 255,905.00 |
| Add profits: 1920 | | 80,615.00 |
| Provision for possible inventory losses—Dec. 31, 1919 | | 8,000.00 |
| Total | | 344,520.00 |
| Deduct: dividends | 35,000.00 | |
| Provision for possible inventory losses | 12,600.00 | 47,600.00 |
| Surplus, December 31, 1920 | | 296,920.00 |
| Add profits: 1921 | | 43,880.00 |
| Provision for possible inventory losses—Dec. 31, 1920 | | 12,600.00 |
| Total | | 353,400.00 |
| Deduct: dividends | 20,000.00 | |
| Provision for possible inventory losses | 9,250.00 | 29,250.00 |
| Surplus, December 31, 1921 | | 324,150.00 |

*Reconciliation*

| | | |
|---|---|---|
| Balance of surplus—per books—Dec. 31, 1921 | | $331,300.00 |
| Add: deferred charges, December 31, 1921 | | 1,950.00 |
| Total | | 333,250.00 |
| Deduct: deferred income—December 31, 1921 | 700.00 | |
| Accrued expenses—December 31, 1921 | 4,200.00 | |
| Unrealized profit on consigned goods | 4,200.00 | 9,100.00 |
| Balance of surplus—per adjusted statement | | $324,150.00 |

No. 3 (10 points):

A corporation issued $100,000.00 of 6% preferred stock on January 1, 1921, with a sinking-fund provision requiring that there shall be redeemed each year out of profits an amount of stock equal to 20% of the profits of the preceding year. The company is not to pay more than 105 for the stock, and any money in the fund which cannot be used to acquire stock at 105 or less is to remain in the fund until purchases can be made.

During 1921 the company made a profit of $29,000.00, and in January, 1922, it created the fund in accordance with the provisions of the stock issue. During February it purchased and retired 56 shares of preferred stock at 103.

Give entries for the establishment of the fund and the purchase and retirement of the stock.

Explain the difference between the operation of a sinking fund for bonds, and a sinking fund for stock.

State whether you think it is obligatory for the corporation to set up a sinking-fund reserve in conjunction with a preferred-stock sinking fund. If you think that the reserve is not obligatory, state whether or not it is advisable, giving your reasons.

If a reserve is created, state what entry is made to establish the reserve and what disposition may eventually be made of it.

*Solution:*

| | | |
|---|---|---|
| Preferred-stock sinking fund ...................... | $5,800.00 | |
| Cash ...................................... | | $5,800.00 |
| To set aside cash equal to 20% of the profits of 1921, to be used for the retirement of preferred stock. | | |
| Capital stock preferred ........................... | 5,600.00 | |
| Surplus ........................................... | 168.00 | |
| Preferred-stock sinking fund ................ | | 5,768.00 |
| To record the purchase of 56 shares of preferred stock at 103, and the cancellation thereof. | | |

The so-called preferred-stock sinking fund is not a true sinking fund. There are three elements to the definition of a sinking fund. A true sinking fund in the accounting and mathematical sense is a fund of assets (a) accumulating at compound interest (b) for the payment of a positive liability (c) at its maturity. A sinking fund for the retirement of bonds at maturity meets all these requirements. The fund accumulates at compound interest, the bonds are a positive liability, and the bonds are canceled at maturity. Even if the company buys for the sinking fund the very bonds for which the fund was established, these bonds may be held alive in the fund until their maturity. In fact, if the bonds are canceled when purchased the fund should be called a retirement fund and not a sinking fund.

In the case of a fund for stock, none of the requirements of the definition is met. The fund is used for the immediate purchase and cancellation of the stock; hence it does not accumulate at compound interest. The stock is not a positive liability, and it has no definite maturity. It would be more exact to call the fund a preferred-stock redemption fund.

The chief practical difference between a bond sinking fund and a stock sinking fund is that the former continually increases until the maturity of the bonds, but the latter is temporarily increased by the cash deposits and forthwith reduced by the purchase and retirement of the stock.

A sinking-fund reserve is not obligatory unless the provisions of the stock issue specifically require it. If there is such a provision, the contract with the stockholders necessitates the reserve. Even though the reserve is not obligatory, it is advisable to create one in order to appropriate profits and reduce dividends. If, in addition to making the sinking-fund contribution, the company pays dividends equal to the amount of its profits each year, it will deplete its working capital, thus jeopardizing future profits. It is better to hold a portion of the profits in surplus, and this is accomplished by setting up the reserve, which is merely an allocation of surplus. By doing so, the company provides for its immediate needs by an issue of stock, and as the stock is paid off the capital is replaced by profits left in the business.

If a reserve is created, the proper entry is a debit to surplus and a credit to the reserve. The reserve may be returned to surplus after the stock is all retired; or if the reserve was set up at the discretion of the board of directors and not in accordance with an agreement with the stockholders it may be returned to surplus at any time. After having been returned to surplus it may remain there indefinitely, or a stock dividend may be issued against it. In fact, a cash dividend may be charged to this surplus, but it would probably be a poor financial policy to do so, for it would merely result in dissipating the assets which the company had acquired through the programme of issuing preferred stock and replacing the capital thus acquired by the retention of profits.

No. 4 (10 points):

In consolidating the statements of a foreign branch with the statements of the home office, it is necessary to make conversions from foreign to domestic currency. At what rates should the balances of the following accounts be converted? Give your reasons.

Fixed assets.
Inventories at the beginning of the period.
Current assets.
Current liabilities.
Nominal accounts.

*Answer:* Fixed assets should be converted at the rate which was current at the date when the fixed assets were acquired. If the acquisitions were spread over a long period of time, there would be several rates. In order to avoid the inconvenience which results from this situation, the home office frequently carries the fixed assets on its own books, taking them up at the date of acquisition and at the rate current at that date. The rate at the date of acquisition should be used because of the fundamental principle that operating profits should not be affected by fluctuations in the market value of fixed assets. If any rate other than the rate at acquisition were used, the resulting dollar valuation would be different from the actual dollar cost, and thus an element of fluctuation of market values would be introduced.

Current assets should be converted at the rate at the date of the statement, because the theory is that these current assets will be converted into cash for the home office and the current rate is the best measure of the amount of cash which will be received from them.

Current liabilities should also be converted at the rate current at the date of the statement, because these liabilities are a deduction from the estimated proceeds of the current assets.

The inventory at the beginning of the period should be converted at the rate which was current at the close of the former period. At that date the inventory in question was a current asset and was converted at the then current rate. The inventory at the close of one period is the opening inventory of the next period, and this inventory should be taken into the statements of the two periods at the same value. In order to accomplish this result the opening inventory should be converted at the rate which was used at the date when it was the closing inventory.

In regard to nominal accounts opinions differ, some accountants favoring the use of an average rate (average of the rates for the period covered by the statement), while others favor the use of the current rate at the end of the period. It would seem that consideration should be given to the question as to whether the profits have been transferred to the home office during the period and thus realized or whether the profits remain at the branch in the form of current assets.

If remittances have been made throughout the year, so that the profits have been converted into domestic cash at various rates during the year, it is preferable to use an average rate. If remittances have not been made and the profits are therefore represented by current assets at the branch at the end of the year, it would seem preferable to use the current rate. The profits will be the same in either case, because of the necessity of making an adjustment for exchange to bring the balance of the branch current account on the home-office books up to or down to the converted value of the net assets at the branch.

No. 5 (23 points):

The A Company's balance-sheet at December 31, 1921, contained the following accounts:

| | |
|---|---|
| Capital stock authorized | $200,000.00 |
| Unissued stock | 30,000.00 |
| Treasury stock (50 shares—par 100) cost | 7,500.00 |
| Surplus | 20,000.00 |
| Capital surplus (from appraiser's revaluation of fixed assets) | 4,500.00 |
| Premium on stock (issued at 110) | 17,000.00 |
| Reserve for sinking fund | 35,320.00 |
| Reserve for extension of plant | 20,000.00 |

On the same date the B Company bought 90% of the outstanding stock at 170 and acquired the treasury stock and the unissued stock at 150.

Compute, for consolidated balance-sheet purposes, the goodwill arising from the transactions.

*Solution:* The goodwill is the excess of the purchase price of the stock over the book value at the date of acquisition. The first question to be faced, therefore, is what items to include in the book value at the date of acquisition. There are three items which require consideration. The reserve for sinking fund should be included because it is an element of surplus, set aside because of a contract with bondholders. The reserve for extension of plant should be included because it also is an element of surplus, set aside because of a financial policy.

But what about the capital surplus arising from revaluation? There may be a tendency to assume that this should be excluded because of the disfavor with which accountants look upon its inclusion in surplus. There are two ways of indicating why it should be included.

In the first place, assume that the holding company had purchased the assets instead of the stock and had taken up these assets on its own books. There is no question that it would have included this additional value in the fixed property accounts and not in the goodwill, assuming that the appraisal was a trustworthy one. Now the consolidated balance-sheet shows conditions comparable to what would have resulted from a purchase of the assets instead of a purchase of the stock.

In the second place, if the capital surplus item is omitted from the book value at acquisition, the book value will be smaller and the goodwill will be larger than if the capital surplus is included. On the other hand, the surplus on the consolidated balance-sheet will have to be correspondingly larger.

In comparing the book value of the acquired stock with the purchase price, it is necessary to deal with the book value after the acquisition by the holding company. That is, any premium paid by the holding company to the subsidiary affects the book value of the stock held by the holding company and hence affects the goodwill.

The net worth of the subsidiary after selling the unissued and treasury stock at 150, is computed as follows:

| | | |
|---|---|---|
| Capital stock | | $200,000.00 |
| Premium on stock: | | |
| Original issue | $ 17,000.00 | |
| Sale to holding company: 350 shares at $50 premium | 17,500.00 | |
| Total | 34,500.00 | |
| Less premium paid on treasury stock purchases | 2,500.00 | 32,000.00 |
| Surplus | | 20,000.00 |
| Capital surplus (from appraisal) | | $ 4,500.00 |
| Reserve for sinking fund | | 35,320.00 |
| Reserve for extension of plant | | 20,000.00 |
| Total book value of all stock outstanding | | $311,820.00 |

| | |
|---|---|
| The B Company acquired: | |
| 90% of the $165,000 outstanding stock | $148,500.00 |
| Unissued stock | 30,000.00 |
| Treasury stock | 5,000.00 |
| Total (or 91.75% of total issue) | $183,500.00 |

The book value of the stock acquired was 91.75% of $311,820.00, or $286,094.85.

| | | |
|---|---|---|
| The price paid was: | | |
| To outside stockholders: | $148,500 × 1.70 | $252,450.00 |
| To A company: | 35,000 × 1.50 | 52,500.00 |
| Total price paid | | $304,950.00 |
| Deduct book value of stock acquired | | 286,094.85 |
| Goodwill | | $ 18,855.15 |

No. 6 (23 points) (ACTUARIAL):

A music house sells pianos on the instalment plan, receiving monthly payments. Pianos cost $600.00 and are sold for $900.00. Interest at 6% a year or ½% a month is charged on unpaid balances of the purchase price. Income each year is computed by taking such a proportion of the total profit as the collections on principal during the year bear to the $900.00 selling price. In addition, income is credited with interest collected and accrued during the year.

A piano is sold August 16, 1921. An initial payment of $50.00 is received and the purchaser agrees to pay the balance in 30 equal monthly instalments, payable on the 16th of each month, beginning September 16, 1921. These equal monthly payments are to be applied first to the interest accrued during the month and second to the principal. As the interest will decrease each month, the payment on principal will increase.

(a) Compute the monthly payment to be made. (The present value of $1.00 due 30 periods hence at ½% per period is $.8610297.)

(b) Set up a table with the following columns:

| Date | Payments | | | Balance of principal |
|---|---|---|---|---|
| | Total | Interest | Principal | |

Enter the payments received in August, September, October, November and December and show the balance unpaid at December 16, 1921.

(c) State the total credit to income during 1921, including profit on sale and interest.

*Solution:*

(a) Computation of monthly payment:

| | |
|---|---|
| $1.0000000 | |
| .8610297 | Present value of $1 at ½% due 30 periods hence |
| .1389703 | Compound discount |

$.1389703 ÷ .005 = $27.79406 Present value of annuity of $1
$850.00 ÷ 27.79406 = $30.58 Monthly payment.

(b) Table of monthly payments:

| Date | Payments | | | Balance of principal |
|---|---|---|---|---|
| | Total | Interest | Principal | |
| | | | | $900.00 |
| Aug. 16, 1921 | $50.00 | ..... | $50.00 | 850.00 |
| Sept. 16, 1921 | 30.58 | $4.25 | 26.33 | 823.67 |
| Oct. 16, 1921 | 30.58 | 4.12 | 26.46 | 797.21 |
| Nov. 16, 1921 | 30.58 | 3.99 | 26.59 | 770.62 |
| Dec. 16, 1921 | 30.58 | 3.85 | 26.73 | 743.89 |
| | 172.32 | 16.21 | 156.11 | |

(c) Computation of total credits to income for 1921:

Since the profit is one-third of the selling price, and since $156.11 has been collected on the $900.00 principal or selling price, the profit for 1921 is ⅓ of $156.11, or $52.04.

Interest totaling $16.21 has been collected, and there is a half month's interest accrued on $743.89, or $1.86.

The total income for 1921, from this sale, is therefore:

| | | |
|---|---|---|
| Profit | | $52.04 |
| Interest: | | |
| Collected | $16.21 | |
| Accrued | 1.86 | 18.07 |
| Total | | $70.11 |

CONSIGNMENTS AND SALES

*Editor, Students' Department:*

SIR: Being a subscriber of THE JOURNAL OF ACCOUNTANCY, I am asking your advice as to the entries necessary to record the following facts:

Suppose a corporation during July, 1920, sends out on consignment $1,000.00 worth of goods. This $1,000.00 represents the selling price. The goods were sent out on consignment with the idea of securing a good distribution of the goods before starting the advertising. A cash discount of 2% was offered on the invoices provided the bill was paid within 90 days, but the consignment was not due net until the advertising started.

Four hundred dollars less the cash discount of 2% or $8.00 was received by the corporation from customers who expected the advertising to make good.

The advertising was delayed and did not start until January, 1921, so that the consignments were not due and payment was not asked until March, 1921.

As the actual cost of manufacturing the goods was only $500.00, it is therefore desired that the accounts on the ledger reflect the consignment outstanding in cost value only, so as not to include in the 1920 business any profit on the consignment. The advertising starting in 1921 naturally sold the goods in 1921, so that the year 1920 did not receive any profit, and the accounts should have been on the ledger at manufacturer's cost instead of at the expected selling price.

Will you kindly favor me with the entries necessary to reflect the above facts as of December 31, 1920? When advising please let me have the entry necessary to adjust the accounts that were paid during 1921, also entry for those who discounted their bills at selling price during 1920.

Yours truly,

St. Louis, Missouri. O. C. U.

*Answer:* It is plainly impossible to tell what entries to make to correct the accounts when no information is given as to the entries already made to record the transactions. All that can be done is to discuss the principles which must be given consideration in determining the entries.

In the first place, while the shipments are referred to as consignments it is not at all sure that they are consignments. The letter refers to a cash discount and states that "the consignment was not due net until advertising started." If this means that it is due net when the advertising starts, and that the goods must be paid for and can not be returned, the transaction is not a consignment. The delay in settlement is merely a peculiarity of the credit terms, and the shipments should be treated as sales.

Assuming that the shipments really are consignments and that the consignees have the option of paying within ninety days and taking a discount or returning the goods or paying for them when the advertising starts, the proper method of recording the shipments would be by a memorandum entry debiting consignments outward, which would be a controlling account with subsidiary accounts for each consignment, and crediting consignment sales. This entry may be made at cost or at selling price, though cost is preferable in order to keep track of the cost of unsold goods on consignment for inventory purposes.

When the consignee settles for the consignment, the memorandum entry should be reversed and a regular sales entry should be made. Now four-tenths of the goods have been sold and the consignment has to this extent turned into a sale. The fact that the advertising had not begun when collections were received merely means that the consignee may not have disposed of the goods, but the consignor has disposed of them and received payment for them and he should take up the profit. There is no more reason for him to wait until the advertising starts and the consignee disposes of the goods than there would be for a wholesale merchant to sell goods to a retailer and wait to take up his profit until after the retailer had also disposed of the goods.

As to the goods on hand in the possession of the consignees for which settlement has not been made, the consignment status still exists and these goods should be carried in the consignor's inventory at cost, $300.00, which is 50% of the selling price of the goods for which settlements have not been received.

### Arithmetical Progression

*Editor, Students' Department:*

Sir: I have come across the following problem in my practice and have as yet been unable to solve it. Will you kindly publish your idea of the proper solution?

A building is to be leased for a term of 21 years at a total rental of $525,000.00. The rental for the first year is to be $10,000.00, with gradual equal increases so that during no year will the rental exceed $30,000.00 and the rental for the 21st year shall be $30,000.00.

Thanking you for your assistance in this matter, I am,

Yours truly,

New York. J. S.

*Answer:* The terms of the problem are self-contradictory. Either the last rent must be more than $30,000.00 or the total rent can not be $525,000.00.

If the first rent is to be $10,000.00 and the last one $30,000.00, the principles of arithmetical progression can be applied to find the common difference or yearly increase. The formula to be used is:

$$D = \frac{L - F}{n - 1}$$

In which D = common difference or annual increase.

L = the last year's rent.

F = the first year's rent.

n = the number of years.

$$\text{Then } D = \frac{\$30{,}000 - \$10{,}000}{21 - 1}$$

$$= \$20{,}000 \div 20$$

$$= \$1{,}000.$$

This would make the rent \$10,000.00 the first year, \$11,000.00 the second, and so on. But this will not produce the total rent of \$525,000.00, which may be proved by using another formula of arithmetical progression:

$$S = \frac{F + L}{2} n$$

In which S = the sum of all the payments.

Applying this formula, the total payments are computed as follows:

$$S = \frac{\$10{,}000 + \$30{,}000}{2} 21$$
$$= \frac{\$40{,}000}{2} 21$$
$$= \$20{,}000 \times 21$$
$$= \$420{,}000$$

If the total payments are to be \$525,000.00, the last payment must be more than \$30,000.00, and the amount of this last payment may be computed as follows:

$$\text{Since } S = \frac{F + L}{2} n$$
$$\frac{S}{n} = \frac{F}{2} + \frac{L}{2}$$
$$\frac{S}{n} - \frac{F}{2} = \frac{L}{2}$$
$$\frac{\$525{,}000}{21} - \frac{\$10{,}000}{2} = \frac{L}{2}$$
$$\$25{,}000 - \$5{,}000 = \frac{L}{2}$$
$$\$20{,}000 = \frac{L}{2}$$
$$\$40{,}000 = L$$

The annual increase in rents may now be computed by the first formula:

$$D = \frac{L - F}{n - 1}$$
$$= \frac{\$40{,}000 - \$10{,}000}{20}$$
$$= \$30{,}000 \div 20$$
$$= \$1{,}500$$

Then the rent the second year would be \$11,500.00; the third year \$13,000.00, and so on.

### Dividends Out of Capital

*Editor, Students' Department:*

Sir: Will you kindly give me an opinion on the following case? A company publishing a well-known popular magazine had issued stock for an equivalent amount of cash paid in. It suffered losses until its balance-sheet, in condensed form, appeared as follows:

| | | | |
|---|---|---|---|
| Net capital and current assets ............ | $250,000.00 | Capital stock ......... | $300,000.00 |
| Deficit .............. | 50,000.00 | | |

Just about the time the magazine had reached this stage and its proprietors were greatly discouraged, it started to run a series of feature articles which suddenly became immensely popular. The circulation and advertising receipts suddenly jumped to figures previously unthought-of.

In the first year after this sudden change of fortune, the corporation earned profits of approximately $40,000, and the directors desired to distribute dividends of $30,000. But there was no surplus out of which to declare dividends. On the contrary, the balance-sheet still showed a deficit of $10,000. In this predicament they called in an accountant who solved the difficulty by directing that a very simple entry be made on the company's journal, debiting a new account to be called "goodwill" to the amount of $100,000 and crediting surplus for a like amount. Then the balance-sheet showed a surplus of $90,000.

There was nothing then to prevent the immediate distribution of cash profits in the form of dividends.

Very truly yours,

Philadelphia, Pennsylvania. H. W. S.

Nothing whatever. The only thing which might have prevented it was a little legal knowledge on the part of the directors, to the effect that a book entry debiting goodwill and crediting surplus does not create earned profits, and that they would become personally liable to creditors in case of future inability to pay the corporation's debts in full. Lacking this knowledge there was nothing to prevent the dividend. Some bitter experience as a result of this dividend might prevent a subsequent one in similar circumstances.

### Loss on Realization of Inventory of Discontinued Line

*Editor, Students' Department:*

Sir: May I ask your kind opinion in the following situation, which actually exists?

A concern making and selling one line of product (product A) and also formerly jobbing another line of product which it did not manufacture (product B) has discontinued altogether the sale of product B but continues the manufacture and sale of product A. At the time of the change in policy a $2,000 inventory of product B, in salable condition, remained on hand. This inventory is still on hand and is carried as a separate ledger account. The nature of product B is such that sales are not likely to occur unless determined sales effort is made or unless expense is incurred, and no sales were made of product B. During the year the $2,000 inventory of product B has suffered loss in value to the amount of $500. This loss in value is credited to the inventory account in the ledger. The question is: How should the debit be classified?

Among the suggestions that have been made, and upon which I should like to have your opinion, are the following:

(1) Cost of goods sold (which aside from this item would consist altogether of items entering into the cost of product A).

(2) A part of "other gain and loss" at the end of the operating statement, with other items that affect net profit but are not considered a part of operations.

(3) Surplus.

Would your answer be the same if a number of sales of product B had been made during the year, it being understood that no expense or chargeable effort had been made to effect such sales?

The distinction between the case stated and the ordinary unsalable inventory items in a merchandising concern is that the inventory in the problem presented by this situation is the remnant of a line of product that has been altogether discontinued, and that so far as its physical condition is concerned the item is entirely salable.

I thank you now for such attention as you can give this inquiry.

Very truly yours,

Cincinnati, Ohio. F. J. H.

It appears that the decrease in the value of the inventory of product B should be charged to surplus. The profit of the last period during which this product was dealt in has been credited to surplus; but the correctness of the profit thus credited to surplus is dependent upon the ability to realize the inventory at the value placed upon it when the books were closed at the end of the prior period. The loss now ascertained on the inventory is a correction of the value placed upon it at that time and is therefore a correction of the profits estimated at that time.

If sales of product B had been made during the period, it would appear that these profits would have been extraneous to regular operations since the company is no longer dealing regularly in product B. Therefore the profit on such sales would be an offset to the shrinkage in value of the inventory, and the net amount should be transferred to surplus as a net adjustment of the value placed upon the goods at the end of the last period during which they were regularly handled.

### Partnership Profits on Sale of Capital Interest

*Editor, Students' Department:*

Sir: Enclosed is a copy of a problem that has been much discussed among the members of the staff during the past few days, along with the several solutions which have been offered during these discussions, and as a reader of the Journal I shall appreciate it very much if you will comment on these solutions, stating under what conditions each would be correct.

Very truly yours,

Atlanta, Georgia. T. W. B.

*Question.*

A and B purchase an invoice of cotton consisting of 200 bales for which they pay $20,000. Of this amount A contributes $12,500 and B contributes $7,500. Later C offers $10,000 for a one-third interest in this invoice, which A and B accept. You are asked to submit figures on which to base the distribution of this $10,000; so that both A and B will receive absolute justice and that they may all continue equally interested in the venture.

*Answers.*

No. 1.

Withdrawal of original investment by A and B:

| | | |
|---|---|---|
| A—withdrawal | $12,500.00 — $6,666.67 = | $5,833.33 |
| B—withdrawal | 7,500.00 — 6,666.66 = | 833.34 |

Premium on sale of 1/3 interest to C:
$10,000.00 — $6,666.67 = $3,333.33

| | |
|---|---|
| A—50% of $3,333.33 | 1,666.67 |
| B—50% of $3,333.33 | 1,666.66 |

Total distribution of $10,000.00 paid by C:

| | Capital | Premium | Total |
|---|---|---|---|
| A ........... | $5,833.33 | $1,666.67 | $7,500.00 |
| B ........... | 833.34 | 1,666.66 | 2,500.00 |
| Total ........ | | | $10,000.00 |

No. 2.
Withdrawal of original investment by A and B:

| | |
|---|---|
| A—withdrawal (as above) | $5,833.33 |
| B—withdrawal (as above) | 833.34 |

Premium on sale of 1/3 interest to C = $3,333.33 as above.

| | |
|---|---|
| A—5/8 of $3,333.33 | $2,083.33 |
| B—3/8 of $3,333.33 | 1,250.00 |

Total distribution of $10,000.00 paid by C:

| | Capital | Premium | Total |
|---|---|---|---|
| A ............ | $5,833.33 | $2,083.33 | $7,916.66 |
| B ............ | 833.34 | 1,250.00 | 2,083.34 |
| Total ........ | | | $10,000.00 |

No. 3.
Withdrawal of original investment by A and B:

| | |
|---|---|
| A—withdrawal as above | $5,833.33 |
| B—withdrawal as above | 833.34 |

Premium on sale of 1/3 interest to C—$3,333.33 divided 50 cents on each $1.00 withdrawn.

| | |
|---|---|
| A—$5,833.33 × .50 | $2,916.67 |
| B—$ 833.33 × .50 | 416.66 |

Total distribution of $10,000.00 paid by C:

| | Capital | Premium | Total |
|---|---|---|---|
| A ............ | $5,833.33 | $2,916.67 | $8,750.00 |
| B ............ | 833.34 | 416.66 | 1,250.00 |
| Total ........ | | | $10,000.00 |

The above problem, submitted by T. W. B., cannot be solved with any certainty because there is no statement as to the ratio in which profits are to be shared. If profits are shared equally, the first solution is correct. If they are shared in the capital ratio, the second solution is correct. In the absence of an agreement, partnership profits are shared equally; therefore, in the absence of a stated agreement, the first solution must be assumed to be correct. I can not see that the third solution would be correct in any circumstances.

### Self Insurance

*Editor, Students' Department:*

Sir: I am a subscriber to your periodical and have followed from month to month the discussions of various items on accountancy, but have failed to find any explanation of the insurance-reserve account, which I understand is kept by several large concerns in the east.

In order that you may pass on it properly, I shall place a set of facts before you and ask you to outline the most feasible method of handling the proposition.

A corporation proposes to carry 50% of its insurance on stock, buildings and fixtures, at the same time creating a reserve on the books of the company which in time will cover any loss that might occur over the amount purchased.

To create this reserve, the company is going to transfer Liberty bonds to this account from the Liberty-bond account, and charge them at the prevailing market value, although the bonds are carried at par.

What entries will be required to set up this account for insurance reserve? Also what entries to cover loss on bonds?

Very truly yours,

X. Y. Z.

When a concern decides to carry so-called self insurance, there may be both a reserve and a fund. At any rate there should be a reserve; the fund is optional.

The reserve should be set up by a charge to profit and loss and a credit to insurance reserve. The amount charged to profit and loss may be determined in several ways, one of the most common being to set up the amount which would otherwise be paid as premium to an insurance company. Some concerns reduce this amount somewhat, on the theory that the premiums paid to an insurance company include the cost of the insurance and a profit, and since the object of carrying self insurance is to save this profit, the charge to profit and loss is reduced to the estimated cost of the insurance eliminating the estimated profit. Another method is to ignore the cost of premiums and compute the reserve on the basis of estimated future losses from fire. This is a very difficult method to apply as fire experiences of the past are an untrustworthy indication of probable losses in the future. When a loss occurs, it is charged against the reserve. In the case mentioned in the letter, where some insurance is carried with insurance companies, only the excess of the loss over the settlement recovered would be charged to the reserve.

If desired, the concern may also provide a fund to replace assets destroyed. This is accomplished by debiting the insurance-fund account and crediting the account of the asset transferred to the fund. Your statement that the reserve is created by transferring Liberty bonds to a reserve account must be incorrect because a reserve is an account with a credit balance. It would be impossible to transfer assets from one account to another and have the second account a reserve with a credit balance. It must be the intention to create a fund. There is a good deal of confusion between funds and reserves, and the mistake in terminology is not unusual.

If Liberty bonds are transferred from the bond account to the fund at a reduced value, debit insurance fund at the market value, debit surplus for the loss taken, and credit Liberty-bond account for the carrying value of the bonds transferred.

### Estimating Profits by Months

*Editor, Students' Department:*

Sir: I shall appreciate it if you will inform me how you would divide profits of an amount of $100,000. The partnership contract between A, B, C and D provides that the profits and losses should be divided as follows: A 40%; B 30%; C 24%; D 6%. Profits for the months of January and February, however, should be divided at the rate of 45% for A and 19% for C.

The bookkeeper of the firm takes the point of view that the total profit of $100,000 should be divided equally over the twelve months of the year and the proportion thereof for the months of January and February should be shared by A 45% and by C 19%. The accountants who audited the books decided that this was an error and the profits of the first three months should be taken as a basis and that two-thirds of this amount represent the profit of the first two months, to be divided at the agreed rates.

Yours truly,

A. W. E.

The auditors are more exact than the bookkeeper, but I believe it is possible to be even more exact, and in a case of this sort, where financial interests of different parties are involved, the computation ought to be as exact as possible. As the auditors propose to use the profits of the first three months as a basis, it must be that the books were closed at the end of March. Therefore the rate of gross profit for these three months can be ascertained. Using this rate of gross profit, it is easily possible to ascertain the approximate inventory at the end of February by the customary gross-profit method. This ought to be a close approximation, as the rate used is the actual rate of profit for the two months involved, modified only by any change which may have occurred in March, which would probably have little effect on the computation. The books will show the purchases and sales for the two months, and with the actual inventory at the beginning of the period and the estimated inventory at the end of the period the gross profit for the two months can be very closely estimated. All that would remain is an analysis of the expenses to determine those which are applicable to the two months in question.

The auditors' proposal overlooks the fact that the profits for January and February might not be anywhere near two-thirds of the profit for the first three months, because of differences in sales and in expenses.

### Adjustment of Partnership Profits

*Editor, Students' Department:*

SIR: Will you kindly give me your solution of the following problem:

A partnership, A and B, has interest in capital and profits for the year 1919 of 75% for A and 25% for B. A customer's account of $1,000 is charged off during that year which results, of course, in A losing $750 and B $250.

The same partnership is upon the basis of 50% and 50% the next year, and the supposed bad account of $1,000 is paid in 1920.

Should that collection when received be credited to surplus, in which case A and B would receive $500 each although it had cost A $750 and B $250 the year before?

I do not seem to find any authority on this question and if you can refer me to such authority as has been printed, will you kindly do so?

Yours very truly,

Boston, Massachusetts. H. H. S.

The collection could not well be credited to surplus because it is not customary for a partnership to have such an account. All profits are divided at once. The question is: Should the collection be credited direct to the partners' capitals in the former ratio or be credited to profit and loss and thus be divided in the new ratio? Theoretically, there seems no question that the only equitable method is to credit the capitals direct in the old ratio. Otherwise A would suffer an injury as the result of a mere book entry. Practically, it might be difficult to apply this theory in all cases, for it might be impossible to ascertain all corrections of prior years' profits as easily as it is done in this case.

In support of the theory stated above, and in compliance with your request for reference to authorities, I am able to quote from an article by Mr. Walton which seems to be directly applicable:

"When the profit-and-loss ratio changes from one period to another, any adjustments of the profit of a prior period must be carried to the capital accounts in the profit-and-loss ratio of the prior period instead of in the ratio of the current period. To illustrate, if the profits of one period are understated, for instance by the understatement of the final inventory, when the error is discovered in a subsequent period correction must be made by credits direct to the partners' capital accounts in the prior year's profit-and-loss ratio. Correcting the error by a credit to profit-and-loss would be wrong for two reasons: first, it would overstate the current period's profit; and second, of much greater importance, it would distribute the profit in an incorrect ratio.

"If a reserve has been set up to meet a future contingency and the contingency has ceased to exist, the reserve should be credited to the partners in the ratio of the division of profits that prevailed at the time the reserve was created, and not in the ratio of the current year, if the rate has been changed."

This seems to cover the point. If a reserve had been set up against the account and later was found to be unnecessary, it should be closed back to the partners in the ratio which existed when the reserve was set up. The fact that the account was actually charged off does not change the principle.

### Federal Taxes and Bonus

*Editor, Students' Department:*

Sir: I have read with interest the answer to many knotty problems in the Journal, and I am wondering if you can advise me on the following:

"A" was the manager of several departments in a store and had an oral agreement with the president that in addition to his salary he was to get 10% of the profit of those departments. No data are available to show if there was any other qualifying condition as to how the profit was to be figured. Now the corporation submits him a statement giving the results of the year's business and in this statement his departments have been charged with a proportion of income tax paid to the government. Now the question in my mind is whether this tax paid to the government is a fair charge against his departments or it is proper to charge it against surplus, pure and simple. Just what would be the correct way to treat this item, and what is the usual way of handling it?

Very truly yours,

Walla Walla, Washington. G. J. P.

A is to receive a percentage of the net profits; the net profits are not known until all expenses have been deducted; taxes are an expense; therefore it is the opinion of this department that it was proper to deduct a portion of the income tax from the profits of the departments in which the manager was interested. The mere fact that the expense of taxes is computed on the basis of profits before deducting taxes does not change the fact that the taxes are an expense.

Since the tax is based on profits, the proper way to apportion the tax among the several departments is on the basis of the profits of the departments.

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It is announced that the name of the Incorporated Institute of Accountants, Commonwealth of Australia, has been changed to Commonwealth Institute of Accountants.

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Hurdman & Cranstoun announce the removal of their offices to the Borden building, 350 Madison avenue, New York.

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Lybrand, Ross Bros. & Montgomery announce the removal of their New York office to 110 William street.

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Abadie, Burgess, Hessenbruch & Tanner announce the removal of their New York office to 50 Church street.

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Courter, Rhyne & Shenton announce the removal of their offices to 30 Church street, New York.

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E. A. Ashdown & Co. announce the removal of their offices to 120 west 42nd street, New York.

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Alfred Rose & Co., New York, announce that they have admitted David Munroe to partnership.

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Herbert S. Greenwood announces the removal of his office to 2 Rector street, New York.

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David Elder & Co. announce the removal of their office to 34 Pine street, New York.

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Leon Brummer announces the removal of his office to 53 Park place, New York.

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Eckes & Dean announce the removal of their office to 40 Rector street, New York.

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Joseph N. Tropp Co. announce the removal of offices to 165 Broadway, New York.

# Terminology Department

Conducted by the Special Committee on Accounting Terminology of the American Institute of Accountants

The Committee on Terminology of the American Institute of Accountants, having prepared a tentative vocabulary in a form convenient for the use of its members, is now engaged in drawing definitions and desires to secure the coöperation and assistance of members of the profession and other readers of the Journal.

Inasmuch as the terms used in balance-sheets and profit-and-loss statements form the basis of the language of accountancy, these terms are of the first importance and will receive the first consideration. It is intended to arrange these words in small groups, each group containing words which are more or less synonymous, and to consider them group by group. First there will be considered groups of base-words such as "profits" and, when definitions have been tentatively accepted, the derivative words such as "gross profits" and "net profits" will be considered. It is proposed to publish from time to time the tentative results at which we arrive and to ask our readers to forward any suggestions or criticisms they may care to make, whether these be different from or agree with the conclusions reached by us.

Our work has been greatly facilitated by the able coöperation of the librarian of the institute who has collated for us from various sources definitions of the words in our vocabulary. These definitions number many thousand and bring out clearly the meanings assigned to any word by recognized authorities. They are studied by the committee before preparing its own tentative definitions, some of which are now submitted.

Before studying these in detail it is well to consider certain general principles which are involved and will demand consideration throughout the work.

In the first place, it will be found that in many cases the correct definition of a word depends upon the subject with which it is used. While there are frequently colloquial or technical meanings with which accountants are not now concerned, there are three branches of science in which they are interested, viz., accounting, law and economics. Generally speaking, it will be possible to find a common definition which will satisfy accountants and will be accepted by lawyers. The economist, however, often requires an entirely different definition and, as accountancy and economics are so closely allied, it seems wise in some cases to give separate definitions.

The second general principle is concerned with the best method of treating those words which are used by accountants so indiscriminately that they have become almost synonymous. Typical of such words are "earnings," "gains" and "profits"; in fact, the dictionaries define "earnings" as "gains" and "gains" as "profits."

This leads to the question: Shall such words be treated as synonyms, using one definition broad enough to cover all meanings, or shall we attempt to assign to each some particular interpretation or idea?

The committee feels that the first course leads to an unnecessary impoverishment of the language, to the throwing away of a goodly heritage. It feels, too, that each word has its individuality and conveys some idea, some shade of meaning, different from any other word. It will, therefore, endeavor to bring out the individuality of each word, thereby enriching the vocabulary and rendering possible shades of meaning and more definite, accurate description than could otherwise be attained.

If these principles be applied to the first group consisting of "earnings," "gains" and "profits," an examination of the accepted definitions brings out the following:

EARNINGS:

The prevailing idea here is the reward for services performed, usually a pecuniary reward for services rendered without the aid of capital.

GAINS:

This includes increment of amount or degree; that which is acquired or comes as a benefit, profit or advantage as opposed to a loss.

The word usually carries the idea of comparison—"Current profits show a gain over those of last year" or a "gain in speed, weight or earning power."

The second meaning of the word is less used now than formerly. "Profit-and-loss" account largely replaces the "loss-and-gain" account.

PROFITS:

This word implies that which remains—is left over—after defraying expenses and providing for loss of capital.

In view of the above, the following definitions are suggested:

EARNINGS:

That which is gained or merited by labor, service or performance; reward; wages; compensation.

The word implies the reward of personal effort, as distinct from return upon investment, e. g., in the expression "earned income" or "unearned income." The word is applicable to individuals rather than to corporations although as applied to the latter it is used by virtue of tax laws synonymously with "income."

In economics the word means the return of any economic good for an economic service and is applicable to supervisory services as well as productive labor.

GAINS:

Increment of amount or degree; that which is acquired or comes as a benefit, profit or advantage as opposed to a loss.

PROFITS:

The gain resulting from the employment of capital in any undertaking; the excess of the selling price over the cost of anything; pecuniary gain in any transaction or occupation. The surplus remaining from the employment of capital after defraying expenses and providing for loss of capital employed.

In economics the term "profit" is used to designate the net return left in the hands of a producer after deducting wages, including normal wages of management, rent, the value of materials consumed and fixed capital expired, normal interest on capital, whether borrowed or owned by the producer, and a sum sufficient to insure against risks. Any surplus remaining due to unforeseen price fluctuations, etc., to fruitful inventions or to exceptionally successful management is profit.

Let us now consider a second group consisting of

INCOME
RECEIPTS
REVENUE

INCOME:

The word expresses the idea of that which has or will come in from any source (excluding a return of capital).

When applied to the affairs of individuals it expresses the same idea as revenue does when applied to the affairs of a state or municipality. It implies cash or its equivalent and is derived according to economists from four sources, viz.:

LAND
CAPITAL
LABOR
BUSINESS ORGANIZATION

RECEIPTS:

These may come from any source, but there is always conveyed the idea of *un fait accompli*—the word means only that which is actually received and, unless qualified in some way, indicates cash.

REVENUE:

The derivation of this word, whether taken from the Latin or the French, indicates the original meaning which has remained unchanged. The word still means a coming back, that is, the return for something put out or invested.

"Revenue" is used by public utilities in conjunction with operating income, but with this exception the word is generally used in the accounts of states and municipalities to indicate the items which could appear under "income" in the accounts of a corporation or individual.

The following definitions are suggested:

INCOME:

Income is increase in wealth measured in terms of money, accruing or received during a given period, and results from the use of capital or the rendering of personal service or both as distinguished from the return of capital. It includes earnings, gains and profits from any source.

In economics "income" means the totality of the advantages enjoyed by a given community, either in the form of goods or services, during a stated period, as a rule one year, as opposed to the totality of goods in existence at a given moment.

RECEIPTS:

That which is actually received, indicating cash (from all sources) unless otherwise described.

REVENUE:

Income of a government derived from taxes, customs or other sources; also used with respect to the operating income of public utilities.

The committee urgently requests criticism on the above. Communications may be directed to any one of the undersigned.

WALTER MUCKLOW, *chairman,*
420 Hill Building, Jacksonville, Fla.
EDWARD H. MOERAN,
120 Broadway, New York.
J. HUGH JACKSON,
56 Pine Street, New York.

# American Institute of Accountants

## REGIONAL MEETING AT BOSTON.

The fourth regional meeting of the New England members of the American Institute of Accountants was held June 5, 1922, at Norumbega Park, Auburndale, Massachusetts. The meeting was called to order at 11.15 a. m. by Alfred P. Ward, chairman, one hundred and sixty-two members and friends being in attendance.

The report of the regional secretary was read and accepted.

At the morning session the following addresses were read and discussed: *The Theory of Business Cycles,* by Ralph B. Wilson; *Present Day Problems in Industrial Accounting,* by Stanley G. H. Fitch; *The Accountant and the Promoter,* by Frederick J. Hillman.

In the afternoon there was a ball game between teams representing Rhode Island and Massachusetts, the latter team winning by a score of 14-4.

The evening entertainment consisted of an informal dinner at 6.00 p. m., at which short addresses were made by Percy A. Guthrie, Charles L. Talbot and A. P. Richardson.

After dinner, the members and guests attended the open air theatre in the park.

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E. Q. Kruchten, H. W. Muench and N. E. Tessem announce the formation of a partnership under the firm name of Edward Q. Kruchten & Co., with offices at 111 west Monroe street, Chicago, Illinois.

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Bruce W. White announces the opening of an office in the Walker building, 17 south Eighth street, Minneapolis, Minnesota.

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Frederick B. Hill & Co. announce the opening of an office in the First National Bank building, Rocky Mount, North Carolina.

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J. E. Graef & Co. announce the removal of their office to 55 John street, New York.

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Ludwig B. Prosnitz announces the removal of his office to 1270 Broadway, New York.

# Book Reviews

BUSINESS ORGANIZATION AND ADMINISTRATION, by J. ANTON DE HAAS. *The Gregg Publishing Co.,* New York. 353 pp.

Dr. de Haas, who is professor of foreign trade at New York University, has given us an admirable little text-book for a short course in the fundamentals of business administration, organization and management. It is, of course, merely a bird's-eye view of business as a whole, but it affords a basis for thorough grounding from which the student may proceed intelligently to more specialized and advanced courses. It is by no means superficial, however, for it contains a wealth of detailed information on every subject it touches from the proper organization of a complicated business, financing an enterprise (two very keen and lucid chapters on this), the problems of management and the wage question to selecting location, planning factory and store buildings, purchasing, selling and advertising, with closing chapters on methods used in foreign trading.

The closing paragraphs of each chapter summarize briefly and clearly the important points discussed in the chapter, a feature not often found in text-books and a most useful one. For reference and collateral reading there is also appended to each chapter a selected list of books usually to be found in the libraries of business schools and colleges, another feature which should be as valuable to teachers as to students.

A thoroughly sound bit of technical work on which the author is to be congratulated. W. H. LAWTON.

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SERIAL BOND MATURITIES, by ARTHUR S. LITTLE. Published by the author, St. Louis. 63 pages.

*Serial Bond Maturities* deals with the problem how to pay off an issue of bonds over a period of years by means of a uniform amount set aside each year, out of which the maturing coupons are paid first, the balance to provide the required sums to retire the bonds themselves within the stipulated period.

The principal part of the booklet consists of thirty-six one-page tables. The first table covers the retirement of an issue in five instalments, the second in six instalments, etc., up to forty instalments. Each table covers rates that range from four to seven per cent. and increase by one-quarter of one per cent. Each table further shows the percentages or "key numbers" that are to be applied to the total of the bonds to be retired and these percentages or "key numbers" vary with the rate of interest payable on the bonds. The "key numbers" are given for "first" and "last maturities," i. e., by applying them to the total amount of the bonds to be retired they will produce the amount of principal that will be paid in the first and in the last period.

In the preface and appendix several examples are given showing how the intervening maturities may be calculated, either by means of an adding machine or by "pencil and paper multiplication," and several time-saving devices are given or suggested.

The booklet is designed for serial issues that fall due at annual intervals and that remain within the aforedescribed limitations as to number of instalments and rates of interest, but mention is also made of semi-annual maturities and unusual rates or denominations. In these cases the use of other bond tables is recommended.

Evidently the booklet is designed for those who are not familiar with the use of compound-interest tables. It is questionable, however, whether the specific methods outlined in the former will be more easily understood by the average banker, business man or clerk than the more general methods given in the latter. Without the slightest doubt the method called for by the interest tables is by far the simpler, provided one knows how to use them.

The principal difficulty that presents itself to the average layman when confronted by such a problem is how to state the problem in terms that themselves will give a lead to its solution. The one in hand could be approached in the following manner:

(a) If the bonds (totaling, say, one dollar) were to mature at one date (say in forty years), their amount with compound interest to that date (say at six per cent. per annum) could be at once determined by consulting the interest tables, ($10.28572).

(b) If annual instalments (say of one dollar each) were to bear compound interest to the end of the same period (forty years) at the same rate (six per cent.) their amount at the end of that period could also be determined at once, ($154.76197).

(c) The "amount" of a certain number of bonds as computed under (a) will of necessity be equal to the "amount" of the required instalments as computed under (b) for the reason that the latter are to pay off the former and the two must therefore be equivalent.

In the above case the problem resolves itself into the following:

(d) What annual instalment will at the end of forty years produce $10.28572 if interest is compounded annually at the rate of 6%—

$$\text{Answer: } \frac{\$10.28572}{\$154.76197} = \$0.066461547$$

or: 6.6461547% of any issue of forty-year six per cent. bonds (the coupons payable annually) set aside annually for forty years will pay the interest and principal of these bonds.

After determining the annual instalment, it may for all practical purposes be rounded off to the next (higher) even hundred and it will then be a simple matter to prepare, usually without the help of adding machine or "pencil and paper" calculations, a schedule somewhat of the following columnar arrangement:

Coupon date
Bonds outstanding
Annual instalments
Coupons payable
Available for retirement of bonds
Bonds retired
Unexpended balance

that will give not only the maturities but also the coupons payable and on the whole will show more completely and in a more convincing manner the various aspects of the solution.

It is, of course, possible that it is asking too much of the average business man to be or to make himself familiar with the use of interest tables, but it does not seem as if the procedure indicated in the booklet will be more easily mastered. Accepting its "raison d'être" it would still seem, however, that the booklet would serve a more practical and more general purpose if the tables would show interest rates ranging from one to eight per cent., the rates increasing by one-eighth of one per cent. and for a larger number of instalments. They would then be serviceable for semi-annual and quarterly redemptions which are often met with in other than municipal loans. A. van Oss.

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FEDERAL INCOME-TAX LAWS, by Barton and Browning. *John Byrne & Co.,* Washington, D. C. 450 pp.

This book is a unique contribution to the literature concerning our complex income-tax law situation. It is essentially a law book, but it is prepared in such a way that any person at all familiar with legal terminology and the method of citing cases can put it to practical use. Its unique features are that it includes all of the tax laws since the first one in 1861, each law is annotated with foot-notes giving brief digests of the points of the cases, and the last six laws are printed in six parallel columns so that the sections are correlated. This last feature is important in the preparation of briefs or of a case on appeal. While the plan of correlation necessarily throws some sections out of their natural order, the arrangement is not at all confusing and it is most helpful to find similar topics as treated by the various laws stated so that they are all before the reader at the same time.

The book contains also all of the miscellaneous acts, provisions of the constitution of the United States and of the revised statutes of the United States which concern these various income-tax laws. It is well indexed and it has a table of cases arranged alphabetically and another one arranged by citations in numerical order. In the annotations the authors do not express opinions but merely digest the cases cited. This volume should prove particularly useful with other income-tax books in which the authors comment upon the law and upon the cases under it. In the annotations the only cases digested are those which arose in the federal courts. Harold Dudley Greeley.

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EVERYDAY USES OF ENGLISH, by Maurice H. Weseen. *Thomas Y. Crowell Co.,* New York, 1922. 447 pp.

Is it because we are growing careless in our use of language or because we begin to know our shortcomings that there is so abundant a supply of new books telling us what to say and how to say it? It seems to be one of the favorite activities of the publishing trade to induce someone to say something on the subject of English and then to offer his lucubrations to a rather undiscriminating public. The man who can write absolutely correct English, French, Italian or other language of civilization is yet to be born. Even our so numerous grammarians wander far from the paths of exactitude, and for that reason some of us are apt to say that when the doctors disagree the rest of us may be forgiven if we err. Nevertheless, there is so much utterly unpardonable error in our common speech that it may be permissible to send forth a liberal mission to reform us. The great trouble is that it is so easy to find flaws in many of the reformative texts. In *Everyday Uses of English* there are many things to which some authors and also some profane persons would dissent. In the matter of punctuation much could be said in opposition to the author, Professor Maurice H. Weseen. (We know full well that punning is a pastime of obliquity, but the temptation is irresistible to hazard the guess that an author with so ungrammatical a name was driven to a passion for correct diction.)

It is, however, when we come to the consideration of business letters that we are principally at outs with our author. We grieve to find that one who condemns so harmless and useful an expression as "attached hereto" or "enclosed herewith" gives the sanction of his approval to business letters containing such atrocities as

"If you are connected with a bank or are thinking of becoming connected with a bank."

"We have no hesitancy in guaranteeing satisfaction."

"If the suggestion just offered is satisfactory to you, wire us at our expense to proceed with your order and then follow, at your convenience, with the financial statement."

"Meanwhile, we stand ready to give your orders prompt attention on our regular standard terms. We shall also be glad to render you any service that we possibly can."

"We shall anticipate your reply with the greatest confidence."

If we were to review the book before us through the spectacles of a purist there would be much more to be said. Purism, however, is not to be expected in every-day English, and the author may be forgiven for not attempting it.

There is much in the book that is good, and the matter is presented in a pleasing, conversational way which will make reading easy. It is far from perfect, but we shall be satisfied when all the members of our staff attain to an equal proficiency in English. A. P. R.

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Escott & Barnett announce the admission to partnership of H. E. Baumgarten, Wade H. Habitt and Clifton R. Escott. The firm hereafter will practise under the name of Escott, Barnett & Co., with offices at 501 Columbia building, Louisville, Kentucky.

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Marwick, Mitchell & Co. announce the removal of their accounting offices to the Lords Court building, corner of Exchange place and William street, New York.

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Alexander Aderer & Co. announce the opening of an office at 84 St. Paul street, Rochester, New York.

# Current Literature

Compiled in the Library of the American Institute of Accountants

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### Income and Excess-Profits

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