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Students' Department

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INSTITUTE EXAMINATIONS

(NOTE—The fact that these answers 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.*)

AUDITING

May 18, 1922, 9 A. M. to 12:30 P. M.

Answer all questions.

No. 1 (10 points):

In listing the balances from creditors' ledger (assumed to be in agreement with controlling account) you find several debit balances. State three causes which may account for these. How would you treat cases arising from each cause?

Answer: First, goods may have been returned to a creditor, or an allowance may have been claimed and charged to his account after the account was settled. The debit should be verified by inspection of a credit memorandum or by correspondence received from the creditor and on file. Mere evidence of shipment of the goods is not sufficient, for such evidence would not show that the creditor has granted or will grant the credit.

Second, advances or deposits may have been made on purchase commitments. These should be verified by inspection of contracts or correspondence on file.

Third, the creditor may have purchased goods which were charged to his account in the subsidiary creditors' ledger instead of to an account with him in the subsidiary accounts-receivable ledger. The sale and consequent debit would be verified by an examination of invoices and shipping records.

The question now arises as to how these debit balances should be dealt with in the books and on the balance-sheet. Debit balances arising from the first cause may be set out on the asset side of the balance-sheet as "debit balances of accounts payable," but there is no necessity of doing so unless they are of considerable amount.

Advances and deposits should be shown as such on the asset side of the balance-sheet, and it would be better to carry them as assets in the general ledger than as debits to personal accounts in the subsidiary ledger.

The treatment of debit balances arising from the third cause would depend on the conditions of each case. Unless an understanding had been reached with the creditor which provided for an offset of the account receivable and the account payable, there should be open balances in both the accounts-payable and accounts-receivable subsidiary ledgers. If there has been no such agreement, the balance-sheet should include the account payable and the account receivable rather than the net amount. If an offset agree-

ment has been reached, the debit balance in the account-payable ledger should be transferred to an account in the subsidiary accounts-receivable ledger, and it should be included among the accounts receivable in the balance-sheet.

No. 2 (15 points):

(a) Give particulars of the nature of the examination you would make of inventories submitted to you as representing merchandise and the operating supplies on hand at the date of the balance-sheet of a retail grocery business operating a chain of stores.

(b) The company's sales are on a "cash" basis. The balance-sheet shows that the only assets are inventories and cash, the inventories representing 90% of the total assets. Would that condition suggest to you the need for any special consideration as to the extent of the auditor's examination of the inventories?

Answer: (a) The verification of an inventory involves a consideration of prices, extensions and footings and quantities. Prices would be verified by examination of invoices. Extensions and footings would be verified in the usual manner, in total or by tests of larger items. As to quantities, it would probably be impossible to make any physical inspection of the goods because of the elapsed time between the balance-sheet date and the audit date and because the inventories are in a number of different places. Various tests could be made which would probably disclose irregularities.

In the first place, the quantities appearing in the inventories could be compared with the deliveries from the central warehouses to see whether the quantities are reasonable or not. For instance, the records at the central office may show that weekly deliveries of about one hundred units of a certain article have been made to one store throughout the year. This gives a good indication of the volume of business done in this particular article, and the quantity of stock which should be carried. If the inventory shows four hundred or five hundred units of this article, there might be reason to believe that the inventory is inflated.

In the second place, comparisons should be made of the various stores. For example, if all the stores showed about the same condition as that described in the preceding paragraph there would be no reason for doubting the accuracy of the inventory, but if the inventories of all of the other stores showed quantities of this particular item equal to about a week's deliveries to the store, there would be reason to be suspicious of the inventory which showed quantities on hand equal to the receipts for four or five weeks.

In the third place, an adaptation of the gross-profit method may be used. Since the stores are all dealing in the same classes of goods, the rates of gross profit should be fairly uniform among all the stores. Any serious overstatement of the inventory at one store might cause enough of a variation in its rate of gross profit to attract attention.

In the fourth place, many businesses running chain stores bill the goods at retail prices, so that billings less income from sales should represent the inventory on hand at selling prices. But this method of verifying the inventory is subject to two objections: in the first place, the system of accounting will have to be very highly developed to take care of mark-ups and mark-downs in a thoroughly satisfactory manner and maintain a balance repre-

senting the present selling price of the goods on hand at the store; in the second place, an overstatement of the inventory to offset unreported cash sales would not be detected unless periodical tests were made by checking the goods actually on hand.

Before making the tests suggested above, it would of course be necessary to separate the merchandise and supplies inventories.

(b) Since the sales are on a cash basis, any understatement of sales for the purpose of concealing a cash shortage would be offset by overstatements in the inventories. This would be particularly true in stores where goods are billed at selling prices, with the intention of maintaining a check on inventories, sales and cash, for in such cases the cash receipts and the inventories at selling price would have to equal the billed price of shipments after adjustments for mark-downs and mark-ups. For this reason the verification of the inventories would be especially important because of the relation of the inventories not only to profits, but also to cash.

No. 3 (10 points) :

State in detail how you would audit and verify the notes receivable of a large trading corporation with several affiliated concerns, giving due attention to collateral, notes discounted, makers, etc.

Answer: In the first place, a distinction should be made between notes received from customers and notes received from affiliated companies, because notes of the first class are presumably current assets to be collected in accordance with the credit customs of the trade, while notes of the second class are likely to be permanent advances to the affiliated companies.

All notes on hand should be examined and checked against the notes-receivable register, comparing the register and the notes as to maker, time, interest rate, collateral and face. The open items of the register should then be totaled and compared with the balance of the notes-receivable account. A schedule should be made up showing these facts if there is no notes-receivable register, and may be made in any case.

The register should contain information of the collateral received with the notes; and this collateral should be examined to see that none of it has been improperly sold or used for unauthorized purposes.

Any notes received otherwise than in the course of trade should be set out as a separate item in the balance-sheet, so that the balance-sheet will show trade notes receivable as distinguished from all others. Any overdue notes should be charged back to the customers' accounts. The notes should be valued in the light of any available information as to note losses in the past and the credit reputation of the various makers.

If the accounts receivable are verified by circularizing, a similar verification may be made of the balance due from debtors on notes, and such verification would be particularly desirable in case of overdue and demand notes, as total or part payments may have been made on these notes without having been recorded.

Bankers and note brokers who have discounted the client's paper should be asked for a statement of the discounted paper held. Discounted trade notes should be separated from discounted notes received from affiliated

companies, because, while the former represent only contingent liabilities, the latter will be shown as actual liabilities if a consolidated balance-sheet is prepared.

No. 4 (10 points):

The T. N. T. Corporation is organized October 1, 1921, to exploit a new and untried patent. On that date it issues its entire capital stock of no par value, 100 shares for cash at $100 a share, and 900 shares for the patent, the latter being expressly stated in the authorizing resolution as "having no cash value." Its fiscal year is fixed as beginning January 1st, and on December 31, 1921, the treasurer makes up the corporation's first income-tax return based on the following

BALANCE-SHEET

Cash	$1,000	capital stock (1,000 shares)	$100,000
Patent	90,000		
Plant and equipment	7,000		
Expenses to date	2,000		
	$100,000		$100,000

Across the face of schedule A of the income-tax return the treasurer writes: "No business done as yet so there is no net income to report." In schedule B he writes:

"Cash paid in	$10,000
"Patent (25% of stock issued, said stock valued at same amount as that sold for cash on same date)	22,500
"Total invested capital	$32,500"

He submits this return and balance-sheet to you for your criticisms. What are they? Give reasons.

Answer: There are several points here which should be called to the treasurer's attention. First, from an accounting standpoint, the capital-stock account should be credited only with the amounts paid for the stock, since it is no-par-value stock. If the patents really had no value there should be no patents account, and the capital stock should be carried at $10,000.

Second, from the tax standpoint, the fact that the patents were stated to have no cash value will not prevent the corporation from establishing the fact that they have a cash value if there is evidence to support such a contention.

Third, the 25% limitation applies to the total stock outstanding at the beginning of the taxable year, and not to the stock issued for the patent.

Fourth, and most important, the company has made no profit during the year 1921 and it therefore has no tax to pay, regardless of the amount of the invested capital. And as 1921 was the last year in which the amount of invested capital affected the tax on corporations, the valuation of the patent has no bearing on taxes.

No. 5 (8 points):

To what extent is it an auditor's duty to concern himself with the validity of transactions coming under his notice?

Answer: The answer to this question depends upon what is meant by validity. The word valid is defined as "sufficiently supported by actual fact," and also "good or sufficient in point of law."

The first definition of valid can hardly have been meant, for since transactions are facts it is difficult to see how they would be supported by facts. If the word entries had been used instead of transactions, the question would mean, Should the auditor determine whether the entries are supported by facts? There is no question that he should.

But since the word transaction is used, the question must mean, Should the auditor concern himself with the legality of the transactions? In other words, if he is convinced that the management of the corporation has committed acts *ultra vires,* such as engaging in a business not authorized by the charter or paying dividends out of capital or without a formal declaration of dividends, is it his duty to advise his client of this fact? I should say that it is his duty, and that advice of this kind is along the modern line which auditors are following in rendering service as general business advisors. Advice to clients is a different matter, however, from publishing such facts in a report.

No. 6 (10 points):

In making up an income-tax return for a client an auditor makes a serious clerical error in calculations. The client files the return as made and pays the tax. Two years later the treasury department calls attention to the error, and it appears that the client has paid a larger tax than he should have paid. What is the duty of the auditor in the case?

Answer: This seems to be a question of professional ethics and business expediency rather than of accounting principles. I should say that the auditor should perform without compensation whatever clerical work was necessitated by his error and compensate his client to his satisfaction, within reasonable limits, for any loss resulting from the tying up of capital by the payment of excess taxes.

No. 7 (10 points):

A corporation has insured the life of its president for its own benefit and is carrying the amount of premiums paid on its balance-sheet. What position should an auditor take in regard to these premiums?

Answer: The corporation should carry as an asset only the cash-surrender value of the insurance policy. The premiums paid during the year minus the increase in the cash-surrender value accrued during the year should be charged off as an expense.

No. 8 (7 points):

Explain the points of difference in procedure in a detailed audit of earnings and expenses and in a balance-sheet audit.

Answer: The detailed audit involves a fairly exhaustive checking of the entries in the various books of original entry against vouchers of all sorts to see that these entries are adequately supported by documentary evidence; it also involves considerable footing of books of original entry and proof of posting.

In a balance-sheet audit, the income is verified by various tests to see whether the transactions are in general recorded in accordance with correct principles. For instance, are consignments recorded as such or as sales? Is a proper distinction maintained between capital and revenue expenditures? Is there provision for depreciation and bad debts? Is proper recognition given to accrued and deferred items? Determining such facts as these

requires only a general inspection of the accounting system and sufficient tests and examination of vouchers to satisfy the auditor that a proper effort is being made to apply correct principles.

No. 9 (10 points):

"Net income" of individuals is defined in the income-tax law of 1921 as "the gross income as defined in section 213 less the deductions allowed by section 214." Name (in brief titles ignoring provisos and exceptions) six items of allowable deductions. What are some unallowable expenses?

Answer: Six allowable deductions:

Business expenses.
Interest paid or accrued.
Taxes.
Depreciation and depletion.
Bad debts.
Contributions.

Some unallowable expenses:

Personal and living expenses.
Special assessments for local benefits.
Life-insurance premiums.

No. 10 (10 points):

The town of X erects a school building from the proceeds of bonds issued for the purpose. The building is estimated to last twenty years. The bonds also mature in twenty years and contain a sinking-fund clause to provide the funds for their payment at maturity. The school board makes no provision for depreciation on the building in the annual tax rate, and a controversy arises in the town as to whether or not such provision should be made. Discuss briefly both sides of this question.

Answer: It is important to distinguish between the relation of depreciation to the tax rate and the relation of depreciation to the revenue statement. The statement of the school district ought to show the depreciation of the school building as one of the expenses of operating the school system, but it is not necessary to include in the tax rate a provision for sinking-fund payments and also a provision for depreciation, unless the taxpayers wish to tax themselves during the next twenty years to pay for the school building which they are now using as well as for the one which they expect to have to build twenty years hence.

COMMERCIAL LAW*

May 19, 1922, 9 A. M. to 12 30 P. M.

NEGOTIABLE INSTRUMENTS

Answer three of the following four questions:

No. 1 (10 points):

To what requirements must an instrument conform to render it negotiable?

Answer: These requirements are set out in section 1 of the negotiable instruments law as follows:

"(1) It must be in writing and signed by the maker or drawer.

* Answered by John C. Teevan, instructor in business law, Northwestern University School of Commerce.

"(2) It must contain an unconditional promise or order to pay a sum certain in money.

"(3) It must be payable on demand or at a fixed or determinable future time.

"(4) It must be payable to the order of a specified person or to bearer; and

"(5) Where the instrument is addressed to a drawee, he must be named or otherwise indicated therein with reasonable certainty."

No. 2 (10 points):

How is a person secondarily liable on a negotiable instrument discharged from liability?

Answer: Section 120 of the negotiable instruments law provides as follows:

"A person secondarily liable on the instrument is discharged:

"(1) By an act which discharges the instrument.

"(2) By the intentional cancellation of his signature by the holder.

"(3) By the discharge of a prior party.

"(4) By a valid tender of payment made by a prior party.

"(5) By a release of the principal debtor, unless the holder's right of recourse against the party secondarily liable is expressly reserved.

"(6) By any agreement binding upon the holder to extend the time of payment, or to postpone the holder's right to enforce the instrument, unless made with the assent of the party secondarily liable, or unless the right of recourse against such party is expressly reserved."

A party secondarily liable is also discharged from liability by failure of the holder to take the proper steps to hold such party; such steps being presentment for payment to the party primarily liable at the proper time and place or proper presentment for acceptance, protest in case of foreign bills of exchange and proper notice of dishonor for non-payment or non-acceptance as the case may be.

Discharge of a party secondarily liable is also possible, under section 122 of the act, where the holder expressly renounces his rights against any party either by so stating in writing or by delivering the instrument.

No. 3 (10 points):

What is the effect of a material alteration of a negotiable instrument and what constitutes a material alteration?

Answer: The effect of such alteration is to release all parties to the instrument who did not authorize or assent to such alteration; but an innocent purchaser for value may enforce the instrument as it was before the alteration. Section 124 of the negotiable instruments law provides as follows:

"Where a negotiable instrument is materially altered without the assent of all parties liable thereon, it is avoided except as against a party who has himself made, authorized or assented to the alteration and subsequent endorsers.

"But when an instrument has been materially altered and is in the hands of a holder in due course, not a party to the alteration, he may enforce payment thereof according to its original tenor."

As to what constitutes a material alteration, section 125 of the act provides that

"Any alteration which changes (1) the date; (2) the sum payable, either for principal or interest; (3) the time or place of payment; (4) the number or the relations of the parties; (5) the medium or currency in which payment is to be made; or which adds a place of payment, where no place of payment is specified, or any other change or addition which alters the effect of the instrument in any respect is a material alteration."

No. 4 (10 points):

Rowe, private secretary for Foster, brought to Foster a cheque for signature payable to cash. The cheque was made out in figures for $50.00, but no words were inserted in the space left for writing. Rowe raised the cheque to $500.00, which Foster's bank paid. Was the bank liable?

Answer: The bank is not liable. It should be noted, first, that this cheque being payable to cash was therefore payable to bearer; second, that it was delivered by the maker, Foster, to Rowe; third, that it was an incomplete instrument. From the wording of the question it must be assumed that the amount in figures, $50.00, was altered by Rowe to read $500.00, and that Rowe also inserted the amount, $500.00, in words in the space left for writing. Technically, the marginal figures on a negotiable instrument are not part of the instrument, but are merely a memorandum of or convenient reference to the amount. Hence the act of raising $50.00 to $500.00 did not constitute a material alteration or a forgery. Section 14 of the negotiable instruments law provides that where an instrument is wanting in any material particular, the person in possession thereof has a prima facie authority to complete it by filling up the blanks therein. This cheque, therefore, was a valid negotiable instrument. The courts have given two reasons why the maker of such an instrument must bear the loss. One is that the maker of an instrument by leaving a blank therein impliedly authorizes the person to whom it is delivered to fill in the blank. The other reason is the negligence of the maker in executing an instrument containing unfilled blanks.

CONTRACTS

Answer two of the following three questions:

No. 5 (10 points):

Define (a) a bailment, (b) a conditional sale.

Answer: (a) A bailment consists in a transfer by one person (the bailor) to another (the bailee) or a holding by such bailee of personal property under a contract or a legal duty, pursuant to which the bailee is obligated to return the same property in its original or altered condition to the bailor or on the order of the bailor to deliver it to a third person. Generally a bailment exists by reason of delivery by the bailor to the bailee under a contract express or implied. Delivery or contract, however, is not essential to the existence of a bailment, as the finder or thief of personal property is technically a bailee.

(b) A conditional sale is one in which the possession of the goods passes from the seller to the buyer, the vesting of title to the goods in the buyer or the revesting of title in the seller depending upon the occurrence or non-occurrence of some condition. Such conditions may be precedent or subsequent. A sale upon condition precedent exists where the title in the goods is not to vest in the buyer until he has performed or fulfilled some condition. A sale on the instalment plan and a sale on approval are both sales upon condition precedent. In a sale upon condition subsequent, the title passes at once to the buyer, subject to being divested on the performance or happening of some specified condition. A "sale or return" transaction is an illustration, as where goods are paid for and delivered on the condition that the buyer may return the goods within a specified time, if he so desires, and receive his money.

No. 6 (10 points):

A, in Chicago, sold certain goods to B in Boston. The goods were shipped to B by express. After shipment, and while the goods were in the possession of the express company, A ascertained that B was insolvent and unable to pay for his purchase. A notified the agent of the express company at Boston, in whose custody the goods were, to withhold delivery to B and to return the goods to A. The goods were, however, delivered to B upon his payment of the express charges. A sued the express company for conversion. Could he recover?

Answer: Under what is known as the seller's right of stoppage in transitu, A can recover. Under sections 57 to 59, inclusive, of the uniform sales act, when the seller learns that either at the time of the sale or subsequent thereto and while the goods are in transit, that is, in the possession of a carrier to whom they were delivered for transmission to the buyer, the buyer was or has become insolvent, the seller may exercise the aforesaid right by obtaining actual possession of the goods or by giving notice to the carrier. He is then entitled to the same rights in regard to the goods that he would have had if he had never parted with possession. Goods are in transit from the time when they are delivered to a carrier for transmission to the buyer until the buyer takes delivery of them from such carrier. In the present case, A having learned after shipment of the goods that B was insolvent, and the goods still being in transit, and A having given notice to the express company while the goods were in transit, the company delivered the goods to B at its peril and is liable to A for damages.

No. 7 (10 points):

What is meant (a) by the words "substantial performance" as applied to contracts; (b) by the term "quantum meruit"?

Answer: (a) The words "substantial performance" as applied to contracts indicate an exception to the general rule that the performance of a contract must be in strict compliance with all the terms thereof. By substantial performance is meant that the party has made a bona-fide effort to live up to all terms of the contract, that there has been no wilful or intentional departure from such terms and that the deviations or defects in performance are of a minor nature only.

As above indicated, the strict common-law rule requires literal compliance with all the terms of the contract, failing which the party cannot recover—or if he is allowed to recover it is on an implied contract and not on the express contract. To apply the strict rule in every case would frequently work a hardship; hence where the terms of the contract involve numerous and complex details (building contracts being a notable example), the courts will allow recovery if the plaintiff can prove substantial performance, a deduction from the contract price being allowed to equalize matters. In courts of equity substantial performance is sufficient, unless the contract expressly provided for strict performance. As to the time of performance, the common-law rule is that time is of the essence of the contract—that is, delivery or performance must be on the date specified. The rule in equity has been indicated. If the contract provides for performance to the "satisfaction" of a party, the rule is that such party is the sole judge as to such satisfaction, where the element of personal taste or fancy is involved, as in the making of a suit of clothes, a portrait, a statue, etc. Where such elements are not involved, that performance which would satisfy a reasonable requirement is held sufficient.

(b) Quantum meruit is a technical term used in pleading and means "as much as he deserved." The action of assumpsit on a quantum meruit is proper where one person has employed another to work for him without any agreement as to compensation, and where, after the work has been performed, the employer refuses to pay. Such an action is brought on the implied promise of the employer to pay the employee reasonable value of his service or as much as he reasonably deserves. Where the rate or amount of compensation was agreed upon, the action would be on the express contract and not on a quantum meruit.

PARTNERSHIPS

Answer one of the following two questions:

No. 8 (10 points):

X acquired the interest of A in the copartnership of A and B by purchase at a sale under execution issued on a judgment against A individually. Subsequently A and B gave a chattel mortgage on firm property to Y, a firm creditor. Were X's rights in the property superior to Y's or vice versa?

Answer: When A's interest was sold to satisfy X's judgment, A ceased to be a partner; in other words, the sale dissolved the partnership. A therefore had no title or interest in the firm property and hence could convey none to Y either by chattel mortgage or in any other way. B's duties, the partnership being dissolved, were to liquidate the assets, pay off the creditors and wind up the business. Such duties do not include the execution of chattel mortgages on firm property. For these reasons the chattel mortgage to Y was null and void, and conveyed no right or interest whatever in the firm property to Y. Hence as far as the chattel mortgage is concerned, X's rights are superior to those of Y.

Y, however, is a firm creditor and as such has superior rights in the firm property to X. The purchaser of the partner's interest in the partnership gets such partner's pro rata share in the firm assets after all firm

debts and liabilities have been discharged and an accounting has been made between the parties. A's interest, therefore, could not be ascertained until Y, together with all the other firm creditors, had been paid. Hence X's rights in the firm property are subject and inferior to those of Y.

No. 9 (10 points):

What is a limited partnership?

Answer: A limited partnership is defined by the uniform limited partnership act as "a partnership formed by two or more persons under the provisions of section 2, having as members one or more general partners and one or more limited partners." Such partnerships are purely statutory and are unknown to the common law. Under the common law all partners are general partners—that is, are subject to unlimited liability for partnership obligations. Limited or special partners are liable for firm obligations only to the extent of the capital they have invested. Section 2 of said act requires persons about to form a limited partnership to sign and swear to a certificate including among other things a statement of the character of the business, firm name, names of partners, amount of contributions, duration of the business, etc. Such certificate must be filed for public record and serves as notice of the limited liability of the special partners. It should be noted that a limited partnership must include at least one general partner whose liability is unlimited. Limited partnerships are not very numerous. Incorporation provides for limited liability with equal if not greater effectiveness, besides having other advantages over a limited partnership.

CORPORATIONS

Answer both the following questions:

No. 10 (10 points):

A corporation is formed in Delaware which is empowered by its charter or certificate of incorporation to do business in all states of the United States. Specify what steps in general should be taken by the corporation before operating in states other than Delaware and what would be the result, if any, of failure to take such steps?

Answer: In all the states other than Delaware, this corporation would be considered as a foreign corporation, and prior to doing business in any other state it would have to comply with the foreign-corporation laws thereof. While these laws are not uniform, the steps to be taken by this corporation would include the filing of a certified copy of its charter with the secretary of state; the payment of certain fees; the filing of a sworn statement setting forth the name of the corporation and its principal place of business, the names of other states in which it is qualified to do business, the character of business intended to be carried on, an estimate of corporate property to be used within the state, the name and address of a resident agent of the corporation upon whom service of summons and other legal process may at all times be made, and the names and addresses of its officers and directors.

If this corporation proceeded to do business in another state without first complying with the foreign-corporation laws of such state, it would

render itself liable to certain penalties or disabilities. These usually include the imposition of a fine, the forfeiture of a right to maintain suits on contracts or other rights and exclusion from the state.

No. 11 (10 points):

Is there any distinction between the "capital" and the "capital stock" of a corporation? And if so explain such distinction.

Answer: Yes, the law recognizes a marked distinction. By the capital stock of a corporation is meant the total amount fixed by the charter or certificate of incorporation paid in or to be paid in as the fund with which the corporation is to do business. It remains a fixed sum in amount and does not vary, except by amendment to the charter, when it again becomes fixed. It is true that the capital stock may fall below the amount as fixed by the charter, but up to such amount the corporate property is to be regarded as capital stock. If there is an excess or surplus, such surplus is not legally part of the capital stock. It may be disbursed in the form of dividends, which is not true of capital stock.

By the capital of a corporation is meant simply the money and other property owned by the corporation at any given time. Capital may be the same as capital stock or, as is usually the case, may be greater or less. Unlike capital stock the corporate capital may vary from time to time.

BANKRUPTCY

Answer the following question:

No. 12 (10 points):

What is the difference between a receiver in bankruptcy and a trustee in bankruptcy?

Answer: A receiver in bankruptcy is an officer appointed by the court to take temporary charge of the bankrupt's property until a trustee is elected. A trustee is an officer elected by the creditors of the bankrupt at their first meeting. He takes title to the bankrupt's estate, liquidates and administers the estate, and pays dividends to creditors. On payment of the final dividend, he prepares his report and account, on the approval of which he is formally discharged. The appointment, classification, duties, etc., of trustees are described in sections 44 to 50 inclusive of the federal bankruptcy act.

FEDERAL INCOME TAX

Answer the following question:

No. 13 (10 points):

Explain the meaning of depreciation and of depletion as used in the federal income-tax act.

Answer: Taking depreciation first, this term appears in the revenue act of 1921 in section 214 (a) (10) and in section 234 (a) (9), the former having to do with deductions allowed to individuals and the latter with deductions allowed to corporations. Both clauses are the same and read as follows:

"In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted."

Hence the term depreciation as used in the act has a special meaning, applying only to improvements related to the exploitation of natural resources. However, depreciation is allowed as a deduction in other business, as provided for in section 214 (a) (8) and section 234 (a) (7), in the following language:

"A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."

This clause is itself an explanation of the meaning of depreciation in the act, although the word itself is not used in the clause.

The term "depletion," as used in the act, is the deduction allowed for the exhaustion and wasting of minerals, oil, timber and other natural resources.

Profits on Canceled Sales

Editor, Students' Department:

Sir: Will you favor me with an answer to the following question:

A agrees to purchase a tract of land from B for $500,000.00 on January 1, 1921, paying $100,000.00 at that time and giving four notes of $100,000.00 each at 6%, maturing in one, two, three and four years. On June 30, 1921, they cancel the contract and notes by mutual agreement; B retains the original $100,000.00 as a forfeited option payment, but in case he sells the land again will return to A any excess of the sale price over $500,000.00, but not exceeding $100,000.00, less an amount equal to interest on $400,000.00 at 6% from January 1, 1921, to the date of re-sale. The land not being resold as yet, what profit (if any) should B take into account on his books at June 30, 1921, and at December 31, 1921, and under what caption should he enter it in his profit-and-loss statement?

B carries the land on his books at a very low figure. He may sell again at any time or price.

Yours truly,
A. D. A.

San Francisco, California.

It appears that B has made a profit of $100,000.00, minus any expense connected with the sale to B and the forfeiture. At the present time B has his land and $100,000.00. It is true that he may have to return a part of the $100,000.00, but this will happen only if he sells the land for more than $500,000.00. That means that he is bound to make his $100,000.00 profit. If he does not re-sell the land he will keep the $100,000.00. If he does re-sell, he will make as a profit the difference between the original cost of the land and $500,000.00, and since he bought at a "very low price" this profit will apparently be more than $100,000.00. Therefore I think that his profit-and-loss statement at June 30th should show miscellaneous income of $100,000.00.

It appears that the interest feature is not operative unless B re-sells. There is no unconditional promise on A's part to pay B interest. Hence there does not seem to be any justification for accruing interest on B's books. That would mean that there would be no additional income to show in the statement at December 31st.

Taxes and Bonus

Editor, Students' Department:

Sir: Regarding the formulas which have appeared in The Journal of Accountancy from time to time for computing commission after deducting federal taxes, in view of the change in the law affecting 1921 and 1922, particularly where the fiscal year ends in 1922, it seems now very difficult to determine the proper amount of commission after allowing for these taxes. The writer has a complex problem in this respect and he suggests that if you would have this problem worked out and published, it would no doubt be of assistance to him and also to other subscribers who have a similar difficulty before them. The following is an outline of the points of the problem:

A bonus of 10% of the net profit is to be allowed to an employee. This bonus is to be based on the profits according to the books, including interest on obligations of the United States, dividends on personal-service-corporation stock, profits on dealings in the corporation's own stock, with deductions for amortization of organization expense and other items which enter into schedule L—reconciliation of net income and analysis of changes in surplus.

The profits according to the books are $49,700.00, and the profits subject to tax (before deduction of bonus) are $49,900.00. The bonus is not to be considered an expense in computing the net profit subject to bonus.

The invested capital is $800,000.00; hence there is no excess-profits tax as the profit is less than 20% of the invested capital. The taxable profit even after the commission is deducted is over $25,250.00, so there is no $2,000.00 exemption from the normal tax. The fiscal year ends on February 28th; therefore the tax would be computed as follows: 10/12 at 1921 rates and 2/12 at 1922 rates.

You will observe that there are a great many unusual conditions that enter into this particular example, and it would be of some satisfaction to the writer to see it worked out in a clear and intelligible form so that the average accountant could work out and prove the result.

Respectfully yours,

A. S. S.

Boston, Massachusetts.

Solution: The tax is composed of two elements:

At 1921 rates: 5/6 of 10% of the net profit, or .50/6 of the net profit.

At 1922 rates: 1/6 of 12½% of the net profit, or .125/6 of the net profit.

Then the total tax is .50/6 + .125/6 or .625/6 of the net profit.

This simple computation gives us a single rate which overcomes any difficulties arising from the fact that the fiscal year covers portions of two years with different tax rates.

Expressing the tax by the letter T, and the bonus by the letter B, we have

$$B = \frac{\$49{,}700 - T}{10}$$

$$\text{and } T = \frac{.625}{6}(\$49{,}900 - B)$$

Re-stating the second equation by eliminating the symbol B and replacing it by the value of B as shown in the first equation, we have

$$T = \frac{.625}{6}\left(\$49{,}900 - \frac{\$49{,}700 - T}{10}\right)$$

The various steps in the process of solving for T are given below:

$$T = \frac{.625}{6}[\$49{,}900 - (\$4{,}970 - .10\,T)]$$

$$T = \frac{.625}{6}(\$49{,}900 - \$4{,}970 + .10\,T)$$

$$T = \frac{.625}{6}(\$44{,}930 + .10\,T)$$

$$T = \$4{,}680.21 + .0104166\,T$$
$$.9895834\,T = \$4{,}680.21$$
$$T = \$4{,}729.48$$

$$\text{Then } B = \frac{\$49{,}700 - \$4{,}729.48}{10}$$

$$B = \$44{,}970.52 \div 10$$
$$B = \$4{,}497.05$$

Proof:

Net taxable profit, before bonus	$ 49,900.00
Deduct bonus	4,497.05
Net taxable profit	$ 45,402.95
Tax:	
At 1921 rates: 5/6 of 10% of $45,402.95	$ 3,783.58
At 1922 rates: 1/6 of 12½% of $45,402.95	945.90
Total tax—as above	$ 4,729.48

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