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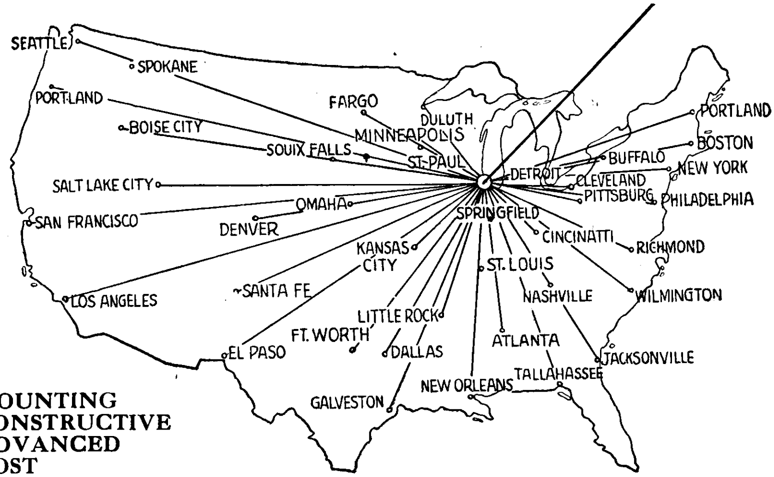

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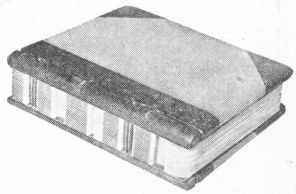

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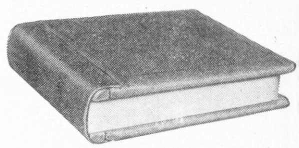

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Accounting for a Modern Hotel*

By A. G. MacMahon

The accounting necessities of a modern hotel differ widely from the simple requirements of the fast-disappearing commercial hotel, conducted on what was termed the "American plan," wherein the guest was charged a modest sum of so much a day, which covered room, meals and services, including, very often, the personal attention of the proprietor. In the huge modern hotels, housing from 500 to 2,000 guests, the room rate is the only thing that is certain by the day, all meals and other services being at rates according to service. This development in the method of conducting hotels involves peculiar accounting necessities not found in other kinds of business.

Practically all modern hotels are operated by what are known as operating companies. They are seldom conducted by the parties or companies owning the lands and buildings. It is usual for a company to be organized to purchase or lease for a long term of years the site for the hotel and to erect thereon the hotel building. An operating company is organized which leases the building, usually at a fixed rental. Ordinarily the company owning the building will furnish and equip the hotel, although this is sometimes done by the operating company. The accounting for the company owning the building presents no unusual features, but the accounting necessities of the operating company become quite complex and diffuse, as the hotel of today is a veritable city within itself. Many of them contain power plants, artesian water systems, printing plants for their stationery and menus, machine shops, carpenter shops, paint shops, as well as upholstering and electrical departments, all of which are usually "below the street" and quite unknown to the traveling public.

* A thesis presented at the November, 1920, examinations of the American Institute of Accountants.

Front Office

The first step in the accounting of the revenue in a hotel is when the guest signs his name on the hotel register and is assigned to a room. Immediately the room clerk or, in the larger hotels, one of the front office clerks, makes out a slip in triplicate or quadruplicate, on which is written the guest's name, room number, rate and date of arrival. This slip is about three inches long and three-quarters of an inch wide. One slip is placed in the room rack, which is arranged numerically by floors, indicating that the room has been sold; one copy is sent to the mail clerk who places it in his rack in alphabetical order; and the other copies are sent to the telephone operators and to "information," and in both places are racked alphabetically. Frequently these slips have the day of arrival printed in a different color for each day of the week. This is to attract attention of the night auditor, one of whose duties it is to see that all bills are rendered weekly.

The register sheets, which should be loose-leaf, are taken by the front-office bookkeeper, as soon as the guest is assigned to a room, and he opens an account for the guest in the guests' ledger. This ledger is sometimes of the loose-leaf variety; but more often it is a card ledger or what is known as a "room book." The room book requires some explanation, as it is to be found only in hotels. It is like a sales book such as is used by salespeople in a department store. It is ordinarily about nine inches by six inches in size and contains fifty pages, i. e., fifty original sheets, and has two carbon sheets to each original sheet. On the front cover it has spaces for the room number, when opened and when closed. Where these books are used a rack is provided, arranged according to room numbers, and under or over each room number there is a space large enough to hold one room book. When a guest is assigned to a room, the bookkeeper takes the book for that room and enters the name, address, rate and date of arrival. The sheets are provided with columns for charges from the café and sundries. When the guest pays his bill the first copy is given him as a receipt; the second copy goes to the auditor to support the collections and accruals; and the original is left in the book for the permanent record. Under this system the rack is the ledger and the room books represent the pages.

The front-office bookkeeper enters in the guests' ledger the charges from the restaurant, laundry or any other service or expenditure on behalf of the guest, which are obtained from the cashbook, restaurant checks, laundry, tailor sheets, etc. The cash credits to the guests' ledger, where the room book is in use, are the care of the cashier, who, when the guest asks for his bill, makes the calculation of the number of days since arrival, totals the bill and enters the payment on his cash receipts sheet. These receipts are checked nightly when the night auditor compares the cash receipts with the room books. Where the loose leaf or card ledgers are used the bookkeeper makes the bill and credits the guest's account from the cash receipts book. The charges and credits to the general books from the front office are made from the summary sheet prepared by the night auditor.

Restaurant and Café

Most modern hotels conduct one or more dining-rooms, and the same system is applicable to all, whether they are termed dining-rooms or restaurants. Each dining-room has its own cashier, who ordinarily is supplied with an imprest working fund in order to make change. As a check, on which is written the guest's order, is necessary for the waiter to procure food from the kitchen and as the food represents money, the control over these restaurant checks must be strictly maintained. Ordinarily the cashier is supplied with the checks from the auditor's office. These checks are numbered serially and the cashier has a sheet provided with columns, one of which is for the numbers of the waiters. Before each meal the waiters secure a supply of checks from the cashier, who enters the numbers of the checks supplied in the column for the number, and as these checks are paid or come through for charging a guest, the cashier checks the number. When the waiter goes off duty he must turn in to the cashier any checks not used. It is usual to charge the waiter for any checks lost. It sometimes happens that when a waiter serves a party he will pocket the money and gladly pay the small fine for losing the check, but as all food is checked out of the kitchen, i. e., the waiter must pass in front of an employee known as the "food checker," who sees what is on the tray and takes the guest's check and prints the prices on it by running it through a register, which also registers the amount of the check, thus recording all food taken out of the kitchen by each waiter, it is possible to prevent such actions. Should the total of the checks turned in to the cashier by a waiter be less than the amount registered against him by the food checker the difference would represent his theft. The checks that are to be charged to the guest's ledger, when the guest instead of paying cash signs his name and room number on the check, should be handled with extreme promptness—which means within a very few minutes—and be sent to the front-office bookkeeper as soon as received by the dining-room cashier; otherwise a guest may finish his dinner and immediately "check out," thus leaving unpaid the amount of his dinner check. The cashier's sheet is provided with columns for check number, cash checks, charge checks and waiters' numbers. Before commencing duty all blank checks in a cashier's possession are listed numerically and then entered in the column for waiters' numbers as they are handed to the waiters. As each check is used and comes back to the cashier with the cash or for charge, the amount of the check is entered in the amount column opposite the respective check number, and then extended into the cash column, if the check is paid, or into the charge column, if the check is to be charged to a guest. The cash is reported on the cashier's daily report, which is the cashier's sheet previously described. It is turned in to the general cashier with the total daily receipts, which, of course, must agree with the total of the cash checks column.

Night Auditor

The night auditor is peculiar to the hotel business. He audits all the transactions of the front office. This work he performs each night from about eleven o'clock to seven. During that time he audits all the transactions of the day ending when he commences work as affecting the front office. One night auditor can attend to from three hundred to four hundred rooms. Thus in the larger hotels several night auditors are required. The hotel business being one in which everything is transient, it is imperative that any errors be found immediately, for the disclosing tomorrow of an omitted charge to a guest may serve no monetary use, as by that time the departed guest may be five hundred miles away. The night auditor is provided with a summary sheet, which may be termed "front-office accounts receivable," "room earnings," or any such descriptive title, but the principle of accruals is the same, regardless of designation. These summary sheets are printed and arranged by floors, with a line for every guest room in the house, and arranged numerically. On the left side is a column for the room number, and, if the system is cumulative, i. e., carrying forward the balance for each room from day to day, there will be a column for balance, columns for room, tailor, laundry, café or dining-room, telephone, transfer, cash and sundries. The sum of these items, excluding the balance in the second column, is placed in the total column, which represents the total charges for the room to the front-office accounts receivable. Following the total column of the charges is a section for credits, containing columns for cash, allowances, delinquent ledger, transfer and total. The sum of the credit columns is inserted in the total column and represents the credit to front-office accounts receivable. Where the cumulative method is in use the debit total column is added to the balance column, from which is deducted the credit total column, thus giving the new balance, which is inserted in the last column headed "balance," which forms the new balance to be inserted in the second column headed balance on the summary sheet for the next day. As before mentioned, these summary sheets are arranged by floors, so that valuable statistics can be prepared therefrom as to room earnings, floor earnings, house count, etc.

The chief peculiarity of the night auditor's duties is that he verifies each transaction independently of the guests' ledgers and finally reconciles with them. The usual procedure is to take the reports from tailor, laundry and telephone, and the cash receipts and cash disbursements sheet, enter all charges and credits on the summary and then prove the result against the original records. He abstracts the charges for dining-room from the dining-room cashier's report, previously described, and posts the charges to the respective rooms. The point here is that the front-office book-keeper charges the guests' ledger from the dining-room checks, which are sent to him during the day by the dining-room cashier, whereas the night auditor posts his summary sheet from the dining-room cashier's report. Here the night auditor commences to verify the work of the front-office force. He checks the guests' ledger by room numbers and on his summary enters the room revenue for the day, which he obtains from the room book or account, as the case may be, the rate being entered on the room book or guest's account. While performing this operation he checks each charge or credit on the guest's account with the charges and credits for that room on his summary, and in this manner verifies all the charges and credits to the individual guest at one time, thus handling the ledger sheet or room book once. This method, whereby he assembles all the charges and credits independently, reduces the likelihood of passing over an error in posting on the part of the bookkeeper. The number of rooms producing revenue on the summary may be confirmed by checking the summary with the room rack, which contains slips for all rooms occupied. It is also advisable to check the rate shown by the slip in the room rack. As a further provision against failure to account for all revenue, the register sheets may be compared with the room rack, which will disclose the presence of a guest registered for whom an account has not been opened. The accuracy of the room rack may further be verified by the housekeeper's daily report, which is a list of all room numbers, on which are noted all rooms actually occupied each night. The column for delinquent is for transferring to the ledger unpaid charges, which are part of the front-office accounts receivable, and is used for keeping charges for departed guests. When a delinquent guest comes to the hotel, these charges are transferred to the guests' ledger.

When the night auditor completes accruing the room earnings and checking all charges and credits he carries the totals of each sheet to a recapitulation sheet, which is arranged in the same form as the summary sheets, and this recapitulation is the basis of the entry placing the revenues on the general books. This sheet is usually provided with a control for the front-office accounts receivable, arranged to show balance yesterday plus charges for today according to the recapitulation sheet, less the credits for today, according to the recapitulation sheet. The result is today's balance, and a trial balance, if taken, should be in agreement therewith. In hotels in which the cumulative system is used, it is possible to have a trial balance each day, as the night auditor's summary sheet will reflect the balance opposite each room, and if the amount as shown by the room book or guest's account is in agreement, there is automatically a trial balance each day, as the summary sheet is in reality the guests' ledger in another form. This method entails more work and requires additional night auditors for a given number of rooms, but the added expense is repaid by the satisfaction of knowing that the front-office accounts are correct. A journal entry is prepared from these daily summaries compiled by the night auditor, charging front-office accounts receivable and crediting room revenue, dining-room, tailor, laundry and telephone revenues.

Other Departments

Many hotels operate coffee rooms or lunch counters, and these are conducted in some ways like the dining-room. Each room has its cashier and the customers' checks are in serial numbers for which there must be account; but as these places are conducted to give quick service, the food is not checked out of the kitchen as it is when sent to the dining-room. The greater part of the food is kept behind the counter and served by the waiters or waitresses. Unduly large portions or items omitted from the customers' checks are left to the superintendents to detect. Payment for all service is usually made in cash. The cashier rings up the sales on a cash register, which is proved by running an adding machine list of the checks and seeing that all checks are turned in. As each customer pays his own check, as a rule, there are, of necessity, some "walk outs"; but as long as the missing checks are within reason it would seem that the receipts are properly accounted when the checks turned in agree with the cash register readings. The cashiers make daily reports from the checks turned in, and the amounts are verified by the night auditor, who makes a reading of all registers nightly. The daily reports as made by the cashiers are turned in with the cash receipts to the general cashier, who charges his cash and credits lunch room revenue on his cash receipts book.

The barber shop, cigar stands, beauty parlor and soda stands are on a cash basis, with a cashier for each stand, and as all sales are rung up on a cash register, these departments present no unusual features. The several cashiers make daily reports which are turned in with the receipts to the general cashier, who credits the respective revenue accounts through the cash receipts book.

Storeroom

The storeroom does not present any accounting peculiarities, although it contains many features unlike a general storeroom that make the reconciling of the inventory on hand very difficult. It is charged through the voucher register with all purchases and is credited through the issue journal with all withdrawals. The supporting bills for the vouchers go through the regular course and must be approved by the proper persons. All goods and materials are withdrawn on requisitions properly authorized. These requisitions go to the auditor's office, are checked as to price and extensions and are entered in an issue journal, crediting the storeroom and charging the department receiving the goods. It would seem that the reconciling of the storeroom account on the general ledger would be simple, as all withdrawals are on requisition, but on account of the perishable nature of much of the stores and the amount of breakage which is not covered by requisitions, the physical inventories are usually at great variance with the book figures, and it is always difficult to overcome these discrepancies.

Auditor's Office

The general accounting offices in a hotel are usually referred to as the auditor's office. Here all transactions are verified before entry on the general books, and in a well organized office the check on all departmental activities is very thorough.

The general cashier ordinarily is in this department. He receives the daily reports from all the cashiers in the house, checks the amount of cash turned in and enters it in the general cashbook, which is provided with columns for each source of revenue. At the end of the month the totals of the various revenue accounts in the cashbook are credited to their respective revenue accounts in the operating ledger, and the total receipts are charged to the various banks in the general ledger, all receipts being deposited intact each day.

The voucher register contains columns for each department and class of expense. All bills are properly authorized for payment and are handled like vouchers in any other business.

Cheques issued in payment of vouchers should be prepared by someone other than the cashier and be entered in the cheque register in the usual manner.

Requisitions should be audited each day. They should be assembled, and a summary should be prepared of the preceding day's business, the total of which will be entered in the issue journal. This is simply a journal entry. At the end of the month the totals of the various columns of the issue journal will be charged to the departments concerned, and the total of all issues will be credited to storeroom.

It will be found that practically all hotels have income from rents, concessions, etc. These should be accrued monthly by a charge to the debtor and a credit to the particular revenue account.

Where the power plant is giving service to outsiders, this service usually will be authorized by proper contracts, and the charges to the customers will be made monthly from the report of the chief engineer, who reports power generated and used, which, of course, can be verified by the meter records. In order to keep a check on the cost of operating the power plant, it is usual to credit the power plant with the amount of power used at a rate somewhat less than that at which it could be purchased from a power company, and this will show as a departmental revenue, but it will be offset by the operating cost of the plant, the revenue from outsiders being the actual revenue.

The payrolls require close attention, and on account of the many changes from week to week the advances on payroll are usually very large. The payrolls should be handled on a time-clock basis and, apart from the heavy advances, have no special features.

All hotels have general ledger accounts for fixed assets, equipment, furnishings, silverware, etc., and these are handled as they would be in any other line of business, with the exception of the furnishings and equipment, which are subject to heavy depreciation and consequently require generous provision for repairs and renewals.

There are many internal checks on departmental activities which are quite complex and interesting but do not come within the scope of a paper on accounting.

Accounting for Crude Petroleum Producers*

By George R. Turtle

This article is intended to deal with the activities of the two principal classes of crude petroleum companies, namely, those engaged in producing crude oil and those developing or prospecting oil lands.

The growth of the petroleum industry in America has been very rapid within the last few years, and it is now common knowledge that the crude oil is obtained from beneath the surface of the earth, sometimes in oil pockets of rock formation, but more often in a certain formation of sand and shale.

To extract or draw the crude oil from the oil pockets or oil formations it is necessary to drill to varying depths—usually from 500 feet to 3,000 feet, according to the depth of the strata or sand in the particular district. The drilling may be done by the company's own employees with the use of its own equipment or it may be done by drilling contractors for a fixed sum or for a price per foot.

For purposes of setting forth the various transactions involved in developing oil properties the following notes are based on the assumption that the company uses its own labor and equipment in development work.

Oil Property Leases

The usual custom of an oil company is to obtain a right in the form of a lease to drill or prospect for oil. The lease in most instances calls for a payment of a royalty of a certain proportion—usually one-eighth—of the oil produced.

Leases are acquired in one of the following ways:

(1) From the owner of the fee or lease for a nominal consideration with a provision for a rental to be paid for the time pending commencement of drilling operations.

(2) From the owner of the lease who has acquired it for the purpose of turning over to an incorporated company in consideration for all or a large portion of the capital stock of that company.

It will be obvious that the capitalization of values of oil lands or leases will be merely nominal or large, according to the mode

* A thesis presented at the November, 1920, examinations of the American Institute of Accountants.

of acquisition. The capitalized value will have an important bearing on the operations of the company. The effect of such capitalization is discussed briefly later in this article.

Leases

Capital expenditures under leases will consist of:

(a) Consideration paid for lease or leases.
(b) Necessary legal transfer and filing charges.
(c) Rentals paid prior to commencement of drilling operations.

In addition to the foregoing there is another important item, viz., that of "proving up" the lease. It is not an uncommon occurrence for oil companies to undertake the drilling of unproductive wells, and the writer wishes to express his opinion as to the propriety of capitalizing expenditures incurred.

When the initial well or wells prove a failure it would appear to be quite correct to capitalize the cost thereof on the theory that such expenditure was necessary to "prove up" the lease. If, however, after the company is successful in bringing in a producer (thereby proving the lease), it should again experience failure, it would appear that the cost of the dry well should be written off as a loss. As an exception to this treatment, initial wells unsuccessful by reason of water trouble, preventing the successful pumping of oil after reaching the oil sand, might justify writing off the cost of such wells as a loss.

When, after a certain time a producing well declines in production to a point at which it is no longer profitable and it is abandoned, the remaining book value of the well should be written off.

Field Improvements and Equipment

Under field improvements and equipment are included all expenditures necessary in building and grading roads; construction of buildings for housing the employees, horses, wagons, automobiles and equipment; boilers and engines; portable drilling equipment; drilling tools and equipment; storage tanks and sump-holes; pipe lines; and any other item of capital assets not strictly applicable to nor permanently a part of any well drilled or being drilled. All these charges are to be absorbed in the production cost as depletion of deposits, discussed at length later in this article.

Well Development Costs and Equipment

The expenditures for well development and equipment are those which are necessary in drilling and completing the well, such as those classified below:

1. Wells requiring use of standard rigs (timber or steel derricks):
   - a. Grading—cost of—for location of derrick.
   - b. Derrick—material (including freight) labor and expense in erecting.
   - c. Rigging—including freight.
   - d. Wages and board of drilling crew.
   - e. Wages and board of miscellaneous labor.
   - f. Supplies used and consumed.
   - g. Fuel and water.
   - h. Depreciation of boiler and engine.
   - i. Repairs and replacement of tools.
   - j. Rental of fishing tackle (used for recovering tools lost in hole).
   - k. Casing (including freight) used in well.
   - l. Cement (including freight) used in shutting off water.
   - m. Torpedoes used in shooting.
   - n. Tubing, valves, pump and fittings for pumping oil.
   - o. Superintendence, overhead, etc., and any other expenditure made in completing well.
2. Wells requiring use of star rigs and portable equipment:
   - a. All items as in previous case, exclusive of cost of derrick and rigging; but, in place thereof, a proportion of depreciation and repairs of portable equipment, together with any supplies necessary while the rig is in use on that particular well.

Expenditures made on account of non-productive initial wells, such as is discussed under the caption "Leases," should be transferred from the well development section of accounts to the lease section—the cost of which will be absorbed in the same manner as other lease expenditures.

The well development and equipment expenditures will be amortized over the production of the respective wells, as described later.

The foregoing comment deals with the treatment of the more important items of capital expenditures. It is taken for granted that the recording of other items will be made according to the generally accepted accounting methods.

Operating and Production

Immediately upon the completion of a well and the commencement of the oil flow, the operating and production costs begin. Substantially such costs may be classified as hereunder, viz:

1. Depletion of deposits.
2. Depreciation and upkeep of field equipment.
3. Operating costs.

Probably the most important of the foregoing items is depletion of deposits.

Perhaps the shortest way to explain the method for determining the value of deposits withdrawn from the oil sands will be by use of an illustration.

Assume that a company, (a), acquires title to or lease of 100 acres of oil land, paying therefor, inclusive of recording fees, etc., $10,000.00, (b), expends for rental prior to commencing drilling operations $200.00, (c), expends on field development, such as road-work, acquiring water for drilling purposes, etc., $1,000.00, (d), expends on well development, including derrick, labor and drilling, miscellaneous supplies and expenses, casing, tubing, suction rods and sundry fittings, $8,800.00—in all a total of $20,000.00.

Assume further, (a), the number of wells which can be drilled on the lease to be 20 and, (b), the estimated total average production for each well to be 20,000 barrels.

We have, therefore, 20 wells with an estimated total production of 20,000 barrels each, or an estimated total production of 400,000 barrels for the lease. This total of 400,000 barrels represents the estimated oil reserve and, if divided into the sum of $11,200.00, will give 2 4/5 cents a barrel, the proportion of lease and field development expenditure which is to be amortized for each barrel of oil produced.

We have now to determine the amount of well development expenditure to be amortized. We obtain this by dividing the cost of well development by the number of barrels of oil which we estimate this well will produce—$8,800 ÷ 20,000—giving as a result 44 cents a barrel.

When a company is capitalized heavily and the larger portion of the capital stock is paid for the lease, a heavy charge for depletion will be made to cost of production, which may and frequently does result in a cost of production greater than the market value of the product.

The question naturally arises as to the basis or method for determining the oil reserve. The following suggestions are for use until the producer is in a position to use his own production figures as a base.

1. In old territory where the logs of other producers are available the estimated oil reserve is determined by the use of the average production figures of that territory.
2. In new territory, where only a few wells have been drilled by the companies operating therein, the log or experience of the average of the producing wells should be used.
3. In new territory or "wild cat" land, there is absolutely nothing on which to base any estimate until the company has operated its own well for a certain period, and one estimate is as good as another.

After the company has been producing for some months it may use its daily and monthly production figures as its base for determining the estimated total oil reserve; and as a company usually does not make up its production and operating statement until some months after commencement of operations, it generally is not necessary for any computations as to estimated reserves to be made until certain active production figures are available. When the company is producing oil, the scientific method of computing future reserves can be ascertained from *Bulletin No. 177, Petroleum Technology 51,* issued by the department of the interior, in which the subject is well and sufficiently covered.

In estimating the total oil reserves for a lease in which only one or two wells have been completed it must be borne in mind that the tendency is to a gradual decline in initial production in all wells subsequently drilled; and when estimating the number of well locations in order to determine the total ultimate production, allowance should be made for this probable decline.

The second item entering into production costs is depreciation and upkeep of field equipment. The amount charged for depreciation really consists of two elements, viz:

a. Actual or physical depreciation.
b. Obsolescence.

For general purposes it is not considered necessary to make any distinction, and it might be advisable to write off the total expenditure for field equipment over the term of the lease, for, as the lease terminates, so also the right to drill further wells terminates. There is, however, no objection to depreciating storage tanks, pipe lines, engines, boilers and other equipment, which can be used after the termination of the lease, on the basis of useful life, provided, as is usually the case, the operator has a perpetual pumping privilege. The latter treatment should not be applied to drilling tools and equipment carried on the books, as this class of asset has practically only a scrap value at the time when the right to drill terminates.

Upkeep of field equipment should be absorbed in the operating costs for the period, excepting in the case where such upkeep is incurred in the development of wells and property. In that event a proportion applicable thereto should be capitalized.

The third item under operating and production is operating costs. These costs consist principally of wages of pumper and helper, fuel, superintendence and similar items not specified, expended in producing and caring for oil produced.

General Information

There should be available at all times certain data which are principally informative, consisting generally of the following:

1. Record of leases:
    - a. Name of property; district or field; and legal description.
    - b. Number of acres.
    - c. Name of assignor or vendor.
    - d. Royalty rate and to whom payable.
    - e. Rental to be paid, when and to whom.
    - f. Date lease or title acquired.
    - g. Date lease commenced and terminates.
    - h. Date lease renewed and terminates.
    - i. Date lease recorded.
    - j. Date lease approved by department of Indian affairs (as applied to Oklahoma).
    - k. Consideration paid; nature of consideration, whether cash, notes, property, bonds or capital stock, and amount of each.

l. Special notes or provisions.
m. Date divisional orders filed and with whom.

2. Record of wells:
    a. Date of commencement of drilling.
    b. Sands encountered, depth of each and feet from surface.
    c. Date drilling completed.
    d. Producer or dry.
    e. If producer, date when put on pump or commencement of flow.
    f. Quantity produced first 24 hours.
    g. Quantity produced each month for first 12 months.
    h. If well is abandoned, give date and cause.
    i. Estimated total reserve for each well, together with revision of computation and date of revision. Basis of estimate should be given.
    j. Total cost of completing each well.
    k. Number of feet of casing and tubing in each well and of each size used.

3. Record of oil produced, giving quantity produced by each well and aggregate total.

This information is compiled from daily reports from the field. The gauges of all storage tanks are taken each morning at seven o'clock and the number of inches of oil in each tank is reported to the office. The office usually has in its possession a chart showing the quantity of oil for each quarter inch of each tank, from which the contents of a tank can be determined at any given time. By taking the difference in measurements from day to day, the daily production is determined, allowance being made, of course, for daily runs.

4. Any other information the state and federal governments require should also be kept in such a manner as to be readily available when required.

Accounting and Recording

The remaining part of this article will deal with the recording of the transactions discussed in the preceding paragraphs.

Generally the organization accounts and entries follow the ordinary custom and comment thereon is unnecessary.

Among the general ledger accounts will be controlling accounts for the following:

1. Leases.
2. Field development and equipment.
3. Well development and equipment.
4. Production expense.

A subsidiary ledger should contain detail of the four accounts above, sufficiently classified to give all the desired information as to expenditures. This subsidiary ledger should contain, (a), a sheet for each lease, showing all charges for cost of lease, filing, recording, etc., fees and rentals; (b), another sheet for each lease with columns headed buildings; engines and boilers; portable drilling equipment; sundry drilling tools; pumps, gauges, etc.; tanks and pipe lines; roads, sump holes, etc.; dry and water holes; (c), a sheet for each well drilled, with a column each for grading; derrick and rigging; labor and board; tools and supplies used; tools, etc., rented; depreciation of equipment; repairs to equipment; casing, tubing, rods, valves, pumps and fittings; sundries.

The voucher register and journal would have columns provided for each controlling account indicated in the foregoing paragraph and columns for selling, office and general expenses and any other controlling account found necessary. A columnar ledger sheet is suggested, in order that a sufficient classification may be made for the more important items entering into the latter class of expenses mentioned.

The regular voucher system should be put into operation, each voucher providing for classification and sub-classification of expenditures under the principal heads. Vouchers will be entered in the voucher register in the usual manner, after which they will be posted direct to the subsidiary records, number of voucher and amount of charge being entered in the appropriate columns. Cash-book and journal items affecting the controlling accounts will be posted to the subsidiary records in a similar manner.

As a general rule oil is sold as soon as a sufficient quantity has been accumulated in the storage tanks. A record should be kept to show the shipments to purchasers. This record should provide for the total shipped, the quantity representing royalty and the net shipment for which payment is to be received.

When a company commences production it usually enters into a contract with a refiner for the sale of its oil. The refiner then constructs, if one is not already constructed, a pipe line to the producer's tanks. When the producer has a sufficient quantity of oil on hand to make a shipment or a run, as it is called, it requests the purchaser to send a man to make the run. The quantity run is determined by measurements made at the tanks by the producer's and the purchaser's men, each checking the other's figures. The man making the run gives the shipper a run ticket, which shows the tank number, measurements before and after run, temperature, gravity and total inches of oil run. A copy of this ticket goes to the purchaser, who, after making deductions for water and sand, remits monthly to the shipper a cheque for payment of his share. He also remits direct to the owner of the royalty a cheque for his share. Invariably the producer has to issue what is known as a divisional order—which is a statement of the divisional interests in the production, which, of course, include royalties. All divisional interests are liquidated direct by the purchaser of the oil, and the producer only receives payment after all royalties and other interests are deducted from the gross amount of oil sales. The company's accounts, therefore, show no entries for royalties.

Branch Accounting for Packing Industries*

By Duncan E. Pedigo

The success of the average branch of the large packing industries throughout the country depends to a great extent upon the individual effort of the local branch manager.

He must be a man who is thoroughly familiar with the packing industry and must be in position at all times to furnish his customers with particular brands of the various kinds of products handled by them. Competition is keen in this industry, and the manager must use good judgment in the selection of his products.

Prompt deliveries of perishable goods are absolutely essential. Failure on the part of the market-keeper to accept late delivery of perishable goods such as beef, pork, mutton, poultry, etc., always results in a loss of from one to five cents per pound. Especially is this true during the summer season on account of the rapid decomposition of this class of products, hauled for several hours in the summer heat and then returned to the cooler. The tainted parts must be cut away, causing a shrinkage in weight, and the balance will have to be sold at a reduced price.

The manager should make special efforts at the end of the week, if necessary, to dispose of all fresh meat on hand. Usually, new consignments are received on Monday of each week and the average buyer will insist on having either the fresh stock or a reduction in price on that carried over from the previous week. This rule does not apply so strictly to beef, which often hangs in the cooler from one to two weeks.

Purchases

Most purchases are made from one of the company's packing plants, usually the one to which the branch house is nearest. These shipments are made in the company's refrigerator cars. The invoice for contents of the car is prepared in quadruplicate—the original being retained by the plant making the shipment; the second copy sent to the home office; the third copy mailed to the branch to which the shipment is made, and the fourth copy placed in the car, to be used at the place of destination in checking the quantities.

* A thesis presented at the November, 1920, examinations of the American Institute of Accountants.

Some criticism might be made of this method of receiving, but, owing to the fact that the cooler man (known in other industries as stock clerk) is held responsible for all stock in his care, he is careful when checking incoming consignments of merchandise.

Local purchases are usually made from an imprest fund in the hands of the branch cashier or from a special fund carried in one of the local banks in the name of the manager and cashier jointly. Special bank accounts are carried only at branches where large local purchases are made. These funds are replenished once a week by the home office.

Perpetual inventory records are imperative. The stock records must show in detail every class and brand of product handled. Not only should the amount be shown in dollars and cents, but also by pieces and weight. Pieces and weight columns are to be balanced as accurately as the money columns, because weekly reports must be made to the home office showing the gross profit of the various departments, the percentage of gross profit to sales and the percentage of shrinkage. The percentage of shrinkage is affected in various ways: atmospheric conditions, kind of refrigeration used in the cooler, cutting, etc. It is essential for the manager to know how his shrinkages occur. Often he is able to discover where errors have been made in entering weights on sales tickets. Inventory shortages are often traced by the abnormal rising of shrinkage figures. If the manager's weekly reports show heavy shrinkages, he is immediately on the alert to find the source of the trouble.

Physical inventories are taken once a week, usually late in the week when the stock is at its lowest. This inventory is taken by the cooler man, assisted by someone from the accounting department, and is a comparatively simple task if the stock is properly kept. After the inventory has been taken, it is compared with the stock records, and, if any discrepancies exist, steps are immediately taken to trace the differences. After the inventory quantities have been approved as correct, they are priced and entered upon the stock records, which are then closed for the week. The figures of the various departments are summarized and entered on a weekly departmental statement.

Where large cold storage stocks, such as eggs, frozen beef and pork cuts, etc., are carried at outside storage houses, a cold storage account should be opened on the general ledger, and to this account should be debited all goods placed in storage and credited to the regular stock accounts, warehouse receipts being taken for the merchandise placed therein. No stock should be withdrawn from storage without a signed order from the manager. When stock is taken out of cold storage, the cold storage stock account should be credited and the regular stock accounts debited. A statement of quantities should be obtained at least once a month from the warehouse and compared with the cold storage account.

Every carcass of beef, veal, mutton, etc., contained in a shipment must be accounted for individually by consignment, lot and tag numbers. These numbers are assigned by the packing house making the shipment. When the invoice is received, a distribution consignment sheet is opened, upon which is entered the lot and tag number and weight of each carcass. These sheets are held open until the entire consignment has been sold.

When a consignment of beef and mutton is received, it is usually in whole or half carcasses, many of which are later cut to fill the requirements of the daily orders. After all cuts have been sold and accounted for, the consignment sales sheet is closed and the profit or loss and shrinkage on each carcass is computed.

The stock clerk, to perform his duties efficiently, must be familiar with the different cuts and their percentages of the whole carcass, as quite often tags are lost and the percentage method must be applied as a means of finding where the posting should be made.

Sales

Each sales ticket is prepared in quadruplicate. The original is retained at the office; the second copy accompanies the delivery of the goods and is retained by the customer; the third copy is used as a means of obtaining the customer's receipt for the delivery of the merchandise and is turned over to the accounting department by the driver at the end of his day's run. They are then arranged in numerical order and compared with the original invoice for the purpose of ascertaining whether or not all deliveries were made as originally invoiced and properly receipted. The fourth copy is merely kept on file for possible call by the general office, but is very seldom used.

At the close of the day's business, all sales tickets are sorted and account must be given for all numbers. After this procedure is completed, a recapitulation of all tickets issued during the day is made, showing the ticket number, number of pieces and amount of sale. The day's sales are then summarized upon a distribution sheet where each kind and brand of merchandise is grouped under its particular classification. The totals of the pieces, weight and money columns are then proved against the totals contained on the daily recapitulations of sales mentioned above.

The daily distribution sheets are summarized at the end of the week; and the totals for the week are entered on the weekly departmental sheet, a separate sheet being used for each department. The departments are generally as follows:

Fresh beef department.
Fresh pork department.
Smoked and dry salt meat department.
Produce department.
Canned goods department.
Pharmaceutical department.

These sheets are compiled in duplicate, the original being sent to the home office and the duplicate retained by the branch office.

Return sales should be distributed and summarized in the same manner as the sales; and these totals should be deducted from the total sales of the items affected. This should be done before posting the sales totals for the week to the departmental profit and loss statement.

Salesmen's Tonnage Reports

It is necessary that the manager be furnished a report of each salesman, showing the total of every class of product sold by him during the week. This statement should also show the gross profit on each class of merchandise sold, a statement of all expenses incurred by the salesman during the week, such as salary, entertainment, traveling expenses, etc., and the net profit or loss for the week.

Each salesman is also furnished with a copy of this statement, which serves as a means of encouragement. If his weekly statement shows a loss, it is obvious to him that such a condition cannot continue indefinitely, and naturally, he will work harder to prevent a recurrence of the same condition the following week.

Some question might be raised as to whether these statements are worth the clerical effort consumed in their preparation, but they have been found by managers to be a source of valuable information. Some salesmen may be making large sales on which the margin of profit is very small and making no effort to sell those products upon which a much larger percentage of profit is to be made, such as canned meats, pharmaceutical products, etc.

The following operating accounts should appear on the general ledger:

Sales. One sales account is sufficient. No advantage is to be gained by carrying a separate sales account for each department, as this information is shown on the weekly reports.

Cost of Sales. The rule applies here that is given under the caption *sales.*

Auto Delivery Expense. Charge this account with wages of drivers, helpers, gasoline, accessories, repairs, garage rent, insurance, depreciation of autos, etc.

Stable Expense. Charge this account with drivers' wages, wagon repairs, horse-shoeing, stable rent, insurance, stable-keepers' wages, horse feed, depreciation of wagons, etc. This account has entirely disappeared from the books of many branches, following the introduction of motor delivery.

Salesmen's Salaries. Charge this account with salaries of all salesmen.

Salesmen's Expense. Charge this account with salesmen's traveling expenses, meals, carfare, telephone, telegraph and other items chargeable to selling expense.

Office Salaries. Charge this account with salaries of clerical assistants.

General Salaries. Charge this account with the salaries of the manager and the men who spend their entire time in the cooler.

Insurance. Charge this account with all insurance except that portion properly chargeable to delivery expense. At the end of each month before closing the books, inventory the unexpired portion and carry into the following month.

Rent. Charge this account with rent of building occupied or other rented storages.

Taxes. Charge this account with local taxes only. Federal income and profits taxes are handled by the home office.

Stationery and Postage. Charge this account with purchases of stationery, postage, etc. All stationery is furnished by the home office and is invoiced to the branch.

Heat, Light and Power. Charge this account with purchases of coal, wood, light, power, etc.

General Expense. Charge this account with sundry items for which no other account appears on the ledger, but under no condition should this account be used as a dumping ground.

Freight and Express. Charge this account with all freight and express. At the end of the period, close to cost of sales that portion applicable to incoming shipments. Deduct from sales the amount applicable to outgoing shipments.

Bad Debts. Charge this account with all losses on customers' accounts applicable to the current year, but only upon advice from the credit department of the home office.

Depreciation. Charge this account with all depreciation for period not directly chargeable to delivery expense.

Balance-sheet accounts are as follows:

Assets

Cash. Impress funds or special funds referred to under the caption *purchases* are the only cash accounts carried in the general ledger. These accounts are reimbursed weekly by the home office for the amount of disbursements as shown by the weekly cash statement. All cash collected on accounts is deposited to the credit of the home office and charged to that account and cannot be drawn upon by the branch.

Notes Receivable. Charge this account with notes taken in payment of accounts or for merchandise.

Accounts receivable. Charge this account with all charges to customers for merchandise purchases, etc. Credit this account with returns, allowances, bad debts written off, notes taken in payment of accounts, etc.

Inventory. Charge this account with purchases, return sales at cost and freight and cartage on inbound shipments. It is not necessary to open an account with each class of inventory items, as this information appears on the weekly statement.

Property Accounts. Charge this account with purchases of buildings, furniture and fixtures, machinery and equipment, real estate, automobiles, etc. Credit this account with sales of property items at the values at which they were taken into the account, debiting or crediting the differences to profit and loss.

Salesmen's Advances. Charge this account with all advances made to salesmen for expenses. Credit this account with expense accounts rendered by salesmen.

Unexpired Insurance. Charge this account with all premiums, other than life insurance. Credit this account with absorbed premiums.

LIABILITIES

Accounts Payable. Credit this account with all purchases. Charge this account with payments to creditors, allowances made by creditors, returned purchases, etc.

Depreciation Reserve. Credit this account with total amount charged to depreciation accounts. Charge this account with total previously credited to account when making sale of property items or writing off obsolete items.

General Office Account. Credit this account with all invoices for merchandise purchases, expenses, equipment, etc., purchased from the general office or any of the packing plants. Charge this account with all cash deposited to their credit, returned purchases, overcharges, returned equipment, etc.

Many accounts ordinarily appearing on the general ledger in other businesses are not shown in the foregoing classification of general ledger accounts because most of the transactions are between the home office and the branch.

No provision has been made for the allocation of expenses to the various departments, as such procedure is not customary. Merchandise purchase and sales accounts are closed weekly, while the operating expense accounts are closed only at the end of each four weeks' period.

Distinctive Features of Cotton Goods Accounts*

By Percival F. Brundage

The accounting requirements for the manufacture and conversion of cotton goods are distinctly different from those of other manufacturing businesses.

The cotton goods industry at the present time is divided into three distinct groups: (1) cotton mills, (2) converters and (3) finishing plants. A self-contained cotton mill manufactures raw cotton into cloth. The converter purchases the cloth, ships it to a finishing plant to be bleached, dyed or printed and sells it to the trade. Most standard cloths are handled in this way. In some cases, however, cotton mills finish their own goods and sell direct to the trade or through brokers and selling agents. Furthermore, there is a tendency today for converters and selling agents to acquire cotton mills and finishing plants in order to control more surely their supply of cloth, but in such cases the threefold distinction is usually maintained through subsidiary organizations.

Cotton Mills

The accounts of a cotton mill are surprisingly simple. The office and administrative staff required to handle a business of over a million dollars a year frequently consists of an executive officer, a superintendent and three or four clerks.

Cotton is the only raw material entering into the product and this is purchased by the executive officer through brokers or a purchasing agent. In some southern mills, near the source of supply, the cotton is purchased on the ground from neighboring farmers. In such cases the grades are more uneven, as several pickings are usually mixed. The general practice, however, is to purchase from sample.

Raw cotton varies in quality according to the length of the staple or fiber and according to the grade. The longest staple is the Sea Island cotton. Next come the Delta and Egyptian cottons. These are used for the finest fabrics. Upland cotton, however, is the great American product and constitutes 70 per cent. of the world's supply. If the fiber equals or exceeds 1⅛ inches in length it is known as long staple, and if less than 1⅛ inches, short staple.

Grades of upland cotton vary four points above and four points below the standard, called middling, upon which prices are fixed.

* A thesis presented at the November, 1920, examinations of the American Institute of Accountants.

The amount of cotton on hand and under contract in any one mill is regulated by the amount of unfilled orders for cloth.

Contracts for the future delivery of cotton are recorded in an order book in which are noted the dates of the deliveries required and subsequently the quantities actually delivered. Each shipment is assigned a code symbol.

Material records of cotton are kept by individual bales and the following system has been found to be very satisfactory where practicable:

Coupon tags of three coupons each, marked respectively 1, 2 and 3, are attached to every bale of cotton purchased. Each coupon bears the code symbol of the respective shipment, the bale number and the weight. The first coupon is detached by the buyer and sent to the mill office as soon as the lot has been accepted. The coupons are there filed by bale number as a record of cotton in transit. When the bales are received at the mill the second coupon is detached and forwarded to the office, where it replaces the first coupon in the file. Bales are usually weighed when received and any difference of weight will be noted upon this coupon. Finally, when the bales are opened, the third coupon is sent to the office as a record of the consumption of that bale.

Practically all cotton is sold sight draft on bill of lading. When invoices for a shipment are received entry is made in the cotton book to record the date shipped, the code symbol, the number of bales, the total weight and the amount. Subsequently the date of receipt is noted therein and adjustment is made to cover any overages or shortages. In some mills entry is made in the cotton book only when the shipment has been actually received, but this practice fails to take into account the fact that ownership of the cotton passes at the time of shipment.

On the credit side of the cotton book is entered the daily consumption of the mill in bales and pounds as reported from the opening room.

At the end of the month the balance in bales, pounds and amount brought forward from the previous month is added to the receipts for the current month and an average unit cost per pound is obtained. This unit is applied both to the consumption for the month and to the inventory at the end.

As an alternative to this method each lot may be kept separate and the daily consumption may be recorded against the lot actually used. Thus *actual* costs instead of averages are applied both to operations and inventories. But, inasmuch as the supply of cotton on hand usually covers only a month's operations, the first method has been found to be sufficiently accurate.

The general ledger account for cotton is charged monthly with the purchases and credited monthly with the consumption.

In an audit of a modern cotton mill it is very important to determine the relative position of the company as regards cotton commitments and unfilled orders. Enough cotton should be maintained on hand, in process and under contract to cover all unfilled orders for cloth. An excessive supply results in the company's being long of cotton and if the price of raw cotton should drop the company would be placed at a disadvantage in quoting prices for future orders. On the other hand, if all orders booked are not covered by cotton on hand and under contract the price may rise and wipe out the expected profit.

At times it may be found necessary to contract for more than immediate requirements in order to obtain the quality desired. In this case the conservative practice is to hedge by selling futures on the cotton exchange. These will be covered when sufficient orders for cloth have been received. In a similar manner if there is a shortage of proper staple or grades it may be advisable to buy futures to protect orders already booked. Trading of this nature is the legitimate function of the exchange. Dealings in futures for purely speculative purposes, however, should be carefully avoided by a manufacturer.

It may be of interest to note that this conservative practice has been generally adopted only in recent years. Previously it was a practice to buy the year's supply in the fall; and the speculation thus undertaken was the cause of nine out of ten cotton mill failures.

The manufacture of cotton cloth may be separated into three major operations: (1) preparation of the cotton, (2) spinning of the yarn, (3) weaving the cloth. The preparation of the cotton consists of opening the bales, picking (to separate the fibers), carding (to remove short fibers and dirt), drawing (to straighten out the fibers) and flying-frames (to draw out and twist the rope or sliver preparatory to the spinning). The spinning consists of a further drawing out and twisting. Between the spinning and the weaving is the warping and slashing of the warp threads to smooth and strengthen the threads and to arrange them in proper order on the loom beam. The cloth is woven by the looms and is finally measured and inspected before bailing.

The actual weight of all cotton processed is known by the weights on the bale tags forwarded to the head office. This has been verified by weighing the individual bales when first received. It is often checked again by weighing in the opening room. The weight of the cloth is calculated by measurement, as in all constructions there are standard numbers of yards to the pound. In the intermediate stages the weight of cotton processed is estimated by the known capacity of the different machines. In this manner the number of pounds of cotton passing through each operation is recorded.

Direct labor is kept by departments and operations. Overhead is distributed in the same way, so that the unit cost of each operation is determined at the end of the cost period by dividing the total cost of each operation by the number of pounds of cotton passing through that operation.

Allowance for waste varies considerably according to the fineness of the yarn and the grades of cotton used. The actual percentage of waste is determined periodically and applied to the succeeding period. The average in the modern mill approximates 12 per cent.

Physical inventories are usually taken semi-annually. At such times the bales of raw cotton are counted and reconciled with the balance, according to the cotton book. The loose and roving cotton is weighed whenever practicable. The spinning frames and looms are commonly inventoried at half their known capacity. Bobbins of yarn are counted and the weight of the yarn thereon is averaged. Finished cloth in the cloth room is measured and baled goods are counted.

In the summarization of the inventories the stocks of cotton, yarn and cloth are all reduced to pounds and the average cotton cost for the period is applied throughout, after allowing for waste in yarn and cloth. In the average mill direct labor is applied to cotton after it has been carded, and overhead only to yarn and finished cloth. In one case known to the writer half of the labor cost of finished cloth is applied to the total weight of cotton, yarn and cloth, plus the cotton cost and 12 per cent. allowance for waste on cloth only. No overhead whatever is included.

In prorating overhead, indirect labor is applied on its percentage of direct labor in each operation; rent, local taxes, insurance, depreciation of buildings, etc., are applied on the basis of the floor space occupied; and power costs on the proportion used by the different processes. Depreciation of machines properly should be calculated by departments on the basis of the expected life of each machine. The more common basis, however, is at a fixed rate of up to $1.50 a spindle, or on a flat rate of 5 per cent. on all properties. These rates would be increased under 24-hour operation.

In pricing the inventories the costs determined during the preceding four weeks' period are commonly used.

The above procedure covers mills that manufacture only grey goods. Where the yarn is dyed the costs of the colored goods are kept separate throughout.

The selling end of the business is usually simple. A selling agent or converter, who often guarantees the accounts, contracts to purchase the total product of the mill. As soon as a sufficient stock of cloth has accumulated it is invoiced and shipped or held for shipping instructions. Working capital is absorbed in the cost of cotton and delay in the collection of accounts is, as far as possible, avoided.

The commissions paid to agents vary from one-half of 1 per cent. to 1½ per cent. for brokers and ordinary agents, and from 3 per cent. to 4 per cent. when collections are guaranteed.

In an audit of the accounts it is important to inquire into the amount of unfilled orders on hand. Special constructions are made to order and it is usual to book orders from two to four months in advance. Every mill, however, manufactures certain standard constructions for stock, especially during dull times. In periods of receding prices and general business depression, such as the present, it is important to determine also the extent to which cancelations have been received.

The general books of a cotton mill are similar to those of other business corporations and call for no special comment.

Converters

The accounts of the converter take up the grey cloth at the mills, carry it to the finishing plant and to the manufacturer, if it is to be made into sheets, pillow cases, etc., and are finally relieved by sale to the trade. Four separate material records are kept, in addition to the record of undelivered grey cloth contracts and unfilled orders for finished goods:

(1) Grey goods held at grey mills.
(2) Grey goods at finishing plants.
(3) Finished goods at finishing plants and at manufacturers' plants.
(4) Finished goods in warehouses or in transit thereto.

Goods invoiced by the mill and not ordered shipped are entered upon the record of grey goods held at grey mills. This record is kept by mills and the contract number, construction, bale numbers, yards and amounts are given. The total of this record agrees with a controlling account in the general ledger.

If the grey goods are sold direct to customers no further stock records are necessary. If they are ordered to a finishing plant, a lot sheet is made out in duplicate for each shipment and the original is sent to the finishing plant as instructions to process the lot, while the duplicate is retained as a record of goods at finishing plants. On the lot sheets are given the lot number, the name of the grey mill, the grey contract number, the construction of the cloth, the finishing contract number, the total grey yards, the individual bale numbers and yardages and any special finishing instructions required. The duplicate copies of the lot sheets are filed by finishing plants according to lot sheet number.

When the lot of grey goods is received by the finishing plant the converter is advised of this fact, as well as of any shortages that may have been found. Record of the receipt is immediately made upon the duplicate lot sheet.

Whenever a portion of a lot is finished the finishing plant advises the converter of the lot number and the new bale numbers and yardages of the finished cloth. These returns are recorded upon the back of the lot sheet. When the complete lot has been finished the total yards returned are compared with the yards sent, to determine if the proper gain has resulted. Except in a few styles, such as piqué, etc., a gain in yardages arises through the fact that the goods are stretched in the processing. This gain is in part offset by a shrinkage in width of from half an inch to two inches. It is further reduced by the fact that the pieces of cloth are sewn together in an endless strip prior to processing and when cut apart the ends are wasted. A real gain, however, results, and it will be found to vary from 1 per cent. for heavy ducks to 8 per cent. for light sheeting. The converter knows from experience the gain to be expected and holds the finishing plant to full accountability if it is not realized.

The finishing plants as a rule measure the goods only after processing and base their finishing charges on this measurement. If, however, the proper gain is not realized the grey yards are measured and if shortages are found the balance of the shipment is held in the grey for further instructions from the converter.

The question of gain in finishing is of considerable importance to the converter. His margin of profit is usually small and he counts on the gain practically to pay the finishing charges. Constant vigilance is therefore maintained to see that full yardage is returned.

At the time when record of the returns is made upon the back of the lot sheet, the finished stock records are charged with the finished yardage. The records of finished stock are kept by finishing plants and constructions. The cloth may be held for a time at the finished plant or may be shipped direct to customers or to warehouses for storage. Finishing plants are sometimes instructed under standing orders from large customers to ship direct to them as soon as part of a lot is finished. Charge to the customer is then made direct from the return on the lot sheet. For shipments to warehouses finished stock at finishing plants is credited and the account goods in storage is charged.

With bleached goods to be manufactured into sheets, pillow cases, handkerchiefs, etc., two lot sheets are necessary, one to cover the bleaching and the other the manufacture. Both processes may be performed at the same plant or at different plants. The manufacturing lot sheet is made out on the same form and in the same way as the finishing lot sheet. In manufacturing, however, there is always a loss and the returns on the lots are watched to see that the contract allowance has not been exceeded.

All remnants at both the manufacturer's and the finishing plant are the property of the converter. Damaged goods are subject to claim by the converter.

Attempt has been made to control the grey goods at finishing plants and the finished goods at finishing plants and manufacturers' by separate general ledger accounts. The labor involved, however, is out of proportion to the information gained and the usual practice is to maintain one general converting account in the general ledger to which are charged all grey goods ordered to finishing plants. This account is credited with the grey cost of sales to the trade or may be left to accumulate until inventory time. Finishing charges, freight, insurance, handling, etc., are charged to separate accounts.

The general accounts of a converter are similar to those of any commission merchant and do not call for special comment.

Because of goods at all times in transit to finishing plants, manufacturers and warehouses, an efficient traffic department is required. This department should take care of all claims for shortage and tracers for delayed shipments, etc.

An insurance department is equally essential to maintain adequate protection over the constantly fluctuating stocks at finishing plants and elsewhere.

In auditing the books of a converting house the proper control of the merchandise stocks is the most important factor to be considered. The correctness of the records can be confirmed by the mills and finishing plants, and physical stock can be taken in the warehouses. Tracers should be produced by the traffic department for all missing shipments.

The pricing of the inventories is very simple if adequate cost records are maintained. Unit prices are on a yardage basis throughout. Grey goods are valued at actual cost plus freight to the finishing plant. The unit cost of the finished yards is determined by totaling the grey cost, freight and finishing charges and dividing the total by the number of finished yards. For partly completed lots the finished yards are estimated on the basis of previous experience.

Care must be exercised to take up full liability for finishing charges on uncompleted lots, inasmuch as finishing plants usually bill for completed lots only. The correct method is to reserve for the total returned yardage on uncompleted lots at the contract price and to deduct any bills rendered on account.

It is a good practice to compare the total amount of grey and finished goods on hand and under contract with the amount of unfilled orders to determine the proportion covered by orders already booked.

Finishing Plants

The operations of a finishing plant consist of bleaching, dyeing, printing and finishing goods belonging to others. Grey goods are sometimes purchased outright to be finished and sold to the trade, but this is not the primary function of the plant.

The care devoted to the keeping of detailed stock records varies considerably as between plants. The lot sheets received from the converting house are the principal records. Receipts are noted thereon and record is made of goods finished and shipped. In some cases it has been found cheaper to pay claims for shortage than to maintain an expensive accounting force to trace differences.

Physical inventories are commonly taken semi-annually or at the specific request of converters.

The general accounts of a finishing plant do not contain any unusual features that require comment.

Receivership Accounting*

By Morris J. Root

Financial embarrassments are numerous at the present time. They are a post-bellum result of wild speculation and war finance. Because of these conditions, the subject of receivership accounting has a timely and increasing interest for the accountant.

R. J. Bennett in his text-book *Corporation Accounting* defines a receiver as "an officer of the court appointed to take charge, custody, control and management of a plant, property or business, to hold and operate or sell out to the best advantage." The receiver, as court representative, takes the property away from the corporation, puts it out of the reach of creditors and places it in such a position as to be secure both from the mismanagement of officers and directors and the incursions of creditors.

Receiverships have often been attacked as a serious invasion by the courts of the rights of private management of private property; and a brief statement of the justification for the so-called invasion perhaps would not be out of place.

Most businesses are today engaged in manufacturing, mining or transportation. These businesses are organized and conducted with properties and implements which are highly specialized and consequently cannot be utilized and are unavailing for any other purpose. To illustrate, take the business of transportation. A railroad consists of narrow strips of land thousands of miles in length, terminals, locomotives, rails, spikes and cars. It is not in the category of a store building or of a farm or of general merchandise, which can easily change hands or be shifted from one type of business to another. "The property of a railroad can be used for no other purpose than the transportation of passengers and commodities." If it is desired to sell this property, it must be sold to another railroad company, for then only will it have more than mere salvage value. Furthermore, the property being a coördinated unit, "no part of it can be separated from the others and sold without destroying a large part of its value." Now, if receiverships were to be eliminated and the creditors of the company permitted to enforce their respective liens, what would be the consequence? The property of the railroad would be pieced,

* A thesis presented at the November, 1920, examinations of the American Institute of Accountants.

the equipment would be hauled off, the terminals taken from it, the organization would be virtually destroyed, the franchises perhaps lost and its entire earning power reduced to nothing. It is evident, therefore, that the property would be completely disintegrated in the contest of creditors. Each set of creditors would make off with a piece of the corpus, and the value of the property, after it had been thus rent, would have a distant relationship to its value as a going concern.

A receivership is an extraordinary remedy for an extraordinary condition. Like a surgical operation, it serves to save the life of a distressed corporation, but it leaves the patient in a weakened condition from which recovery is admittedly slow. It is, however, absolutely necessary in order to prevent the complete destruction of the business and to conserve the value of the company's property. Essentially, it is a measure intended to protect in every respect the rights of all parties concerned.

There are two kinds of receivers: receivers in equity and receivers in bankruptcy. Since the purposes of their appointment and their particular functions are different, it is desirable that a clear line of demarcation be drawn between these two officers of practically the same court.

In bankruptcy, whether voluntary or involuntary, the purpose of appointing a receiver is to preserve temporarily the property until a trustee is elected. The receiver's powers are limited and his tenure of office is brief. He takes possession of all the property of the bankrupt with the expectation of its ultimate disposal and with the understanding that the amounts realized shall be applied to the liquidation of the bankrupt's debts. If the owner makes a voluntary application, there is seldom a need for the appointment of a receiver. The creditors come together and proceed immediately to the election of a trustee. It is the duty of the trustee to take charge of the entire property, to turn it into cash as quickly and advantageously as possible and to apply the proceeds to the liquidation of the claims against it.

In involuntary proceedings, a petition is filed in the federal courts in the judicial district in which is the bankrupt's business. The bankrupt is served with a copy of the petition and given usually about three weeks in which to file his reply. The court will not appoint a receiver unless one of the following conditions exist.

a. A suit by creditors having a lien, mortgage or judgment, there being imminent danger of the property being lost, wasted or misapplied.

b. A suit by stockholders, when there is fraud and mismanagement on the part of some of the stockholders.

c. In foreclosure proceedings, to prevent the disintegration of the property concerned.

d. In dissolution proceedings to protect the interests of all parties.

The receiver, having been duly appointed, is given charge of the property until the election of a trustee. This is usually done at the first meeting of creditors, held thirty days after the owner or the corporation has been adjudged bankrupt by the court.

The purpose of appointing a receiver in equity is to continue the business, frequently as a preliminary step to reorganization. The receiver in equity usually takes only a part of the property and uses it in whatever way seems best for the liquidation of the more pressing current claims of creditors. A condition of insolvency does not necessarily exist. The liquid assets may not be sufficient to meet the maturing obligations; the management may have permitted a tie-up in its current resources; the business may be financially embarrassed—but even these contingencies do not necessarily point to the insolvency of the firm. Its total assets, more or less in unrealizable form, really may exceed the total liabilities; yet, the business cannot pay its pressing obligations and it therefore becomes necessary to turn over the property to a representative of the owner and his creditors, appointed by a court of equity, for the purpose of satisfying the more urgent and insistent claims and for the purpose of preserving the property from needless dissipation.

The powers and liabilities of receivers may be considered together, because with every responsibility and power there comes a corresponding duty or obligation. The order of the court appointing a receiver and all other orders that emanate from the court will determine to a large extent the duties and responsibilities of the receiver. These orders are also the first matter of interest to the accountant. He should be fully acquainted with them. They are the instructions by which both the receiver and the accountant are guided, and the former particularly must see to it that he follows out the instructions in every detail.

Upon his appointment, the receiver takes title to the personal property. All real estate must be conveyed to him. He may institute suit to recover assets belonging to the firm. On the other hand, no suit can be brought against him without the permission of court. He has been called the executive hand of the court and, as such, unwarranted interference with his work may amount to contempt of court. The receiver may compromise claims, sell assets and promote reorganization. However, express authority from court is absolutly essential for the undertaking of any new business. Under his general authority, he takes all the books of the corporation, he manages and operates, and his acts will be enforced by court unless they are proven fraudulent.

To execute his duties, the receiver requires funds. Usually two sources are available for obtaining these necessary funds. First, there is access to the excess of operating income over operating expenses; second, receiver's certificates may be issued. These are evidences of debt, issued only upon specific authority from court. They are prior claims, taking precedence over all existing debts. The receiver may continue or refuse to continue existing contracts and leases. If he decides to continue them, all debts created as a result of such continuation become preferred claims and the receiver must use the income from his operations first for the liquidation of these claims. Receivers often manage so unskilfully that upon completion of their work there is very little left for the creditors. In such cases there is no redress, unless the receiver has acted fraudulently or is proven guilty of gross negligence. Should the receiver do anything of an important nature without authority of court, he is personally liable for any loss resulting from such act. He is, however, not to be held for any lack of ability or business talent—the courts have erred in their appointment.

Turning to the question under consideration, accounting for receiverships, we find many plans and schemes in actual practice. Every receiver displays his personality in the methods pursued; and his knowledge or ignorance of accounts will determine to a large extent the system in vogue. For instance, some use single entry; others, double entry. Some take all the assets and liabilities into account; others consider the assets and the liabilities only as the claims are proved and allowed. Some take the assets at book valuation; others, at appraised or receiver's valuation. Some use the subsidiary records of the company and continue the bookkeeping as before. The general practice, however, seems to be to open a separate set of records for the receiver wherein all the official transactions are recorded. The rule of keeping a careful record of all the cash receipts and disbursements is followed invariably by all.

The accounting for receivers may be simple or complex, according to circumstances. There is no prescribed method or system for keeping the accounts of a receiver. The accountant enlists his personal judgment in outlining the system and manner of keeping the books. One thing is certain and unvarying. The records must fulfill their designated purpose. The receiver was entrusted with property; accordingly he must render a full accounting of his stewardship, and the records must thoroughly, concisely and clearly set forth all his activities.

The subject under consideration can be subdivided and discussed under five headings, following each other in natural sequence, and all involving specific but kindred principles of accounting. They are:

1. The entries made when opening the books of a receiver.
2. The recording of transactions during the receiver's administration.
3. The entries made at the settlement of the estate and when closing the books of the receiver.
4. The intermediary and final reports of the receiver.
5. The company's records during the receivership and the adjustment of the accounts at the beginning and the end of the receivership.

The subject will be discussed in the manner outlined.

With the order of the court before him, the accountant makes a prompt and expeditious audit of the asset accounts. The principles of a balance-sheet audit are applicable at this point. It is necessary to take a physical inventory of the merchandise on hand; outstanding cheques should be added to the bank balance; accruals calculated; depreciation charged off; all the necessary reserves created—in short, the entire procedure is similar to the work done at a normal conclusion of a fiscal period.

Having established the condition of the asset accounts and their respective reserves at the date of the receivership, the receiver's books can be opened. A charge is made upon the receiver's ledger to the various asset accounts. A credit is made to the various reserves belonging to the accounts and a credit for the net balance is posted to an account called "Estate of John Doe, in receivership," or "The X. Y. Z. Corporation, in receivership." The opening entry would appear as follows:

Cash	$200.00	
Accounts receivable	5,000.00	
Inventory	45,000.00	
Machinery and fixtures	15,000.00	
Reserve for bad debts		$500.00
Reserve for depreciation, machinery and fixtures ...		3,000.00
Estate of John Doe, in receivership		61,700.00

To record book value of assets taken over by order of court.

The various accounts as entered must be properly classified. The principles of classification of accounts are as applicable to the ledger of a receiver as to the ledger of any prosperous concern. If any of the asset items taken over have liens against them, proper notation of these liens should be made on the accounts. But all liabilities are for the present completely disregarded. At this stage of the work, one is bound to meet the difficulty of determining the status of merchandise ordered and shipped prior to the financial embarrassment of the business, but received by the receiver after his appointment. The shipper, had he known of the receivership, could have stopped the goods in transit. However, the merchandise has arrived and the receiver may accept it. What should its status be? Is the shipper an unsecured creditor or is the debt an obligation against the receiver payable at one hundred per cent.? In point of equity the receiver should accept only goods which he intends to use during his administration. In that case, the invoice for the merchandise should be fully paid and charged as an operating cost of the receivership.

In considering the next division of the subject, the recording of transactions during the period of receivership, we are met with nothing new in principle. Care must be taken at all times to keep a complete record of all transactions. The receiver will often be ordered by court to pay some of the claims existing prior to his appointment. Preferred items, such as wages, rent and taxes, will also be paid upon order of court. Certain expenses are incurred by the receiver and they must be met. Assets will be sold and funds realized therefrom. In addition there will be the general income from the usual and continued operation of the business. In regard to all the above, two considerations must be taken into account. Briefly stated they are: (a) there must be a complete record of every act of the receiver; (b) an ample and clear distinction should be drawn between payments made on account of obligations existing prior to the receivership and disbursements made for the receiver's own transactions. This latter point causes a great deal of trouble. It is difficult to make fine distinctions. There is a great deal of overlapping of the two classes of payments; questions of priority are continually presenting themselves for solution; and the receiver must act cautiously and deliberately, obtaining the advice of counsel or consent of court upon all moot questions.

The receiver should close his books periodically, the closing period agreeing with the regular fiscal period of the business. Uniformity in the accounting and continuity of the records should always be the aim. This is desirable for comparative purposes, so that prospective purchasers of the business property or prospective financiers may be readily presented with uniform statistical records, showing clearly and definitely the results of operation for prior years and for the period of the receivership.

The receiver's closing entries will depend upon the nature of the termination of the receivership. After operating for a time, and having shaped things into order, the receiver may be ordered by court to sell the residue of the estate and liquidate the entire business. Or a reorganization may take place without any foreclosure proceedings. Again, very often, it may be advisable to go through foreclosure proceedings, to be followed by reorganization and recapitalization.

In any of the above cases, the receiver first closes his books and adjusts his ledger accounts in order to determine the final status of the estate. He opens a profit and loss account and shows the results of his operation, connecting these results with a financial statement. Having established the net book value of the assets on hand, he will proceed to liquidate, if it is so ordered by court. This involves the preparation of realization and liquidation accounts, showing the receipts of cash from the sale of assets, disbursements for all expenditures, payments of all claims in their respective order, i. e., preferred claims, first. Any balance remaining as a result of the liquidation will go to the proprietors or stockholders of the business.

When a reorganization takes place without foreclosure, the receiver returns the property to the reorganized company, after deducting the necessary funds for the settlement of all outstanding receiver's obligations. The entries upon his books are the reverse of those made at the opening of the books. He charges the "Estate of John Doe, in receivership," and credits the asset accounts that he is returning.

If, as is often the case, foreclosure proceedings have been ordered by court, these proceedings to be followed by reorganization, the receiver's acts and entries upon the books will be regulated by the orders of the court. All property sold will be delivered by the receiver to the purchasers, and the receiver will charge himself with the funds received and credit the proper asset account. As part of the reorganization plan, the purchasers by agreement with the various creditors and lien holders will often assume all liabilities, pay off dissenting bondholders and provide the funds necessary for financing the reorganization. The receiver, though acquainted with all the terms of the settlement, is not much interested in the details of the reorganization plan. Upon his books are shown only the sales of assets, proceeds from such sales, disposition of funds and form of settlement of the outstanding obligations. He closes everything by a transfer of all the open accounts into the "Estate of John Doe, in receivership," account.

In considering the question of intermediary and final reports for a receiver, the accountant will be guided by the desires of counsel for the receiver. There is no standardized form for these reports, as each case brings out its own peculiarities. The receiver may make periodic reports or submit only a "first and final account," depending upon the nature of the case, the amount involved, the duration of the receivership and other factors. One thought must be predominant in the preparation of these reports. They must not be mere accumulations of figures, unintelligible and purposeless schedules and exhibits, but rather clear, concise, non-technical, convincing presentations and explanations of the receiver's undertaking, his operations and the results thereof.

The first report will show schedules of inventories and properties taken over, carefully divided and analyzed as to their forms (liquid or fixed), location and whether pledged or free. It will also show all the liens on the property. The receiver will also prepare schedules of all the creditors as shown by the books. These claims are to be classified under the respective headings of preferential claims—such as taxes, wages and rent—fully secured and partly secured creditors with details as to the nature and amount of security, all unsecured creditors and contingent liabilities.

After the first report and as the receiver is progressing in his work, he will submit, from time to time, intermediary reports. Quoting from H. C. Freeman's article on *Accounting for Receiverships* in the October, 1917, issue of THE JOURNAL OF ACCOUNTANCY:

> The objects to be served in the preparation of these reports are: (a) to demonstrate the extent to which the liquidation of the property taken over has proceeded; (b) to indicate the changes which have occurred in the status of the property; (c) to show the results of the operation of the property by the receiver; (d) to enable the court to appraise the value of the services of the receiver. All these purposes to a substantial extent can be accomplished by the presentation of accounts in the form known as an account charge and discharge. The receiver charges himself with:
>
> (1) The assets at the date of the receivership (or at the date of the last report), exclusive of permanent or fixed assets;
> (2) Additions to such assets since discovered;
> (3) Increments upon realization of such assets;
> (4) Amounts realized from the sale of permanent or fixed assets;
> (5) Amounts realized from the sale of receiver's certificates;
> (6) Increases in the amounts of receiver's liabilities;
> (7) Gross income from the operation of the property.
>
> The receiver credits himself with:
>
> (1) Preferred or other liabilities of the company paid;
> (2) Decreases in the assets stated as taken over at the date of the receivership;
> (3) Losses on realization of such assets;
> (4) Expenditures on permanent or fixed assets;
> (5) Receiver's certificates repaid;
> (6) Decreases in the amount of receiver's liabilities;
> (7) Interest charges paid;
> (8) Expenses of operation of the property;
> (9) Receivership expenses;
> (10) The assets at the close of the period covered by the report, exclusive of permanent or fixed assets.

The report should also contain comparative balance-sheets, showing conditions at the time of the previous report and conditions now. In addition, it may contain a profit and loss account and a summary of the cash transactions.

Before the court authorizes any payment or distribution of funds, an auditor is appointed by court to audit and examine the receiver's accounts and to pass upon all claims submitted. The auditor places an advertisement in the newspapers, giving public notice of his appointment and orders the filing of all claims. These claims are first reconciled with the books of the company and passed on to the auditor for final approval.

The final report of the receiver is a summary and complete accounting of his stewardship. It outlines what property is to be returned to the business, the amounts of the unpaid obligations, the results of the receiver's operations, etc. This report, chiefly a résumé of the receivership, helps the court to a large extent to determine the amount of remuneration due to the receiver for his services. The compensation is usually either a fixed percentage of receipts or disbursements of cash or a round sum, depending upon the volume of the work, the time spent and the responsibility involved.

The last topic for consideration is the method of handling the books of the financially embarrassed company during the period of the receivership. These books may be adjusted to meet the new conditions or abandoned until reorganization takes place. The most desirable plan is to keep them in harmony with the receiver's books as to all interrelated matters. When the property is turned over to the receiver, an account is opened with him on the general ledger as "A. B. receiver." This account is charged with every asset turned over and credited with every reserve for the particular asset.

During administration by the receiver, all liabilities prior to the receivership paid by the receiver are recorded by a credit to the receiver's account and a charge to the respective liability account. The books must continue to show all recurring liabilities such as interest, rentals and all other obligations not assumed by the receiver himself.

Upon the termination of the receivership, the plans of the reorganization having been formulated and completed, the company's books will be adjusted to show exactly what has occurred. The assets returned by the receiver are charged upon the books and credited to the receiver's account. The profits and losses that resulted from the receivership are reflected by a debit or credit to the receiver's account. All claims and liabilities allowed by the court auditor are entered upon the books as obligations of the business and, if incurred by the receiver, are charged to his account. The net balance of the receiver's account will show the net worth of the company. In most cases, the capital accounts will have undergone certain changes as a result of the reorganization. These must be entered in the books. The old capital, surplus or proprietorship accounts are closed and the new capitalization is recorded, in accordance with the figures and plans prepared and executed by the committee on reorganization.

In conclusion, it may not be amiss to digress a little from the specific subject under consideration and express the writer's amazement at the apathy prevailing in the ranks of the professional accountants to the consistent and systematic refusal of the courts to recognize the accounting profession in their appointments of receivers. It is indeed to be regretted that many of these appointments have gone to personal and political friends as plums, and they who are best fitted to handle this kind of work have been flatly disregarded and ignored. The advantages of appointing accountants as receivers of large enterprises have long been openly appreciated and recognized in England and in Scotland. Skilled in accounts, familiar with commercial law and usage and acquainted with business of almost every description, it would seem that the accountant is particularly fitted and adapted to the intelligent handling of the complicated tasks of receivers. Our courts have failed to adopt this point of view and many a receivership, because of incompetent administration, has netted only enough to pay the receiver's fees and expenses.

It is to be hoped that the near future will bring with it a better understanding of the status of the accountancy profession in this country and a reform in the selection and appointment of receivers.

The Journal of Accountancy

Official Organ of the American Institute of Accountants

A. P. RICHARDSON Editor

EDITORIAL

Where the Dollar Goes

What becomes of the dollar we pay in federal taxes?

Most of us grumble and most of us pay, but few of us know why we pay or for what we pay. Yet it is salutary to know such things. The man or corporation or nation which stumbles blindly along without knowledge of financial position and the causes of it is likely to come to grief. It is well to know even the worst.

THE JOURNAL OF ACCOUNTANCY is primarily concerned with all that makes for fiscal health. For that reason, and with utter disregard of political inference or implication, we present a statement of the destination of the dollar of federal taxation. The bald facts are sufficiently eloquent. They seem to us so significant that we have it in mind to carry them at the head of these editorial pages for several months to the end that the readers of this magazine may not forget.

According to the federal appropriations for 1921—and this year differs little from its immediate predecessors—

OF THE DOLLAR OF TAXATION THE GOVERNMENT USES

To pay for past wars	*Ta pay for present defense*	*To pay for all other governmental activities*
68 cents	20 cents	12 cents

Concerning Ourselves

This April number of THE JOURNAL OF ACCOUNTANCY is something of a jubilee publication, for it marks the homecoming of the magazine and the unification of all the interests of the American Institute of Accountants under one roof in the institute's own building. This consummation has been in the minds of many leaders of the profession for years past and now that at last it is a fact there is cause for hearty rejoicing among all the members of the great national organization—and we believe that there is also cause for rejoicing by the constantly increasing numbers of readers of THE JOURNAL OF ACCOUNTANCY.

At such a time it is a pleasant and honorable custom to indulge in autobiographical reminiscence. When good things have been accomplished it is pardonable to take pride in them. Furthermore it seems to be a characteristic of publishers to take a more than usual pride in their productions. All these reasons and some more beside are the instigation of these few notes concerning ourselves.

In 1903, when public accountancy was merely an infant, certain wise men came to the conclusion that the profession needed an official mouthpiece. There had been a few attempts to establish accounting magazines but none had been an unqualified success, and it had become evident to many accountants that a magazine worthy to represent the profession could be produced only by the united effort of a large group of men interested in the progress of accounting.

Accordingly a corporation known as the Accountancy Publishing Company was formed, and, with apparent disregard of the unlikelihood of financial return from their investment, accountants in many parts of the country subscribed the preferred stock of the company. The common stock was held chiefly by the American Association of Public Accountants.

The company thereupon began the publication of THE JOURNAL OF ACCOUNTANCY, a magazine similar in appearance to the present number. Accountants came generously to the support of the magazine and articles of great importance and value were contributed without thought of compensation.

The welcome accorded to the new magazine was cordial but not general. It did not pay expenses and a deficit, which the American Association of Public Accountants was compelled to make up, occurred with striking regularity at the end of each year. In such circumstances it was not to be expected that the circulation would increase rapidly. The funds available were insufficient for a general campaign of publicity. The editorial and business direction of THE JOURNAL was a matter of secondary importance to those at the head of affairs. In a word, the magazine was asked to run itself. The marvel is that during those early days the quality of material supplied to readers remained high. It is not marvelous that the financial results were deplorable.

At last matters reached a crisis. The funds of the publishing company were exhausted, it became necessary to pass the hat for funds to make up a deficit of something over $3,000 and there was a fear that further efforts to obtain assistance might be futile.

The time had come, however, when the magazine had so established itself that with a small amount of intelligent effort the expense of production should have been equaled by the revenue. Every new periodical publication goes through a time of establishing when the outgo exceeds the income. That is the period in which the heavy mortality occurs. Those that survive the early years generally endure.

At the end of 1911 it seemed wise to dissolve the Accountancy Publishing Company, transfer ownership of the magazine to the American Association of Public Accountants and engage a publishing company to undertake the business management under supervision of the association.

In fulfilment of the plan the association entered into a contract with the Ronald Press Company of New York to publish the magazine for five years, with an option of renewal of contract for a further five years under certain conditions.

The editorial control was assumed by the association. By the joint efforts of the American Association and the publishing company the circulation of the magazine was stimulated and although the progress was not rapid it was substantial. When the American Association assumed ownership the circulation was about 1,400. Today it exceeds 15,000 a month.

In 1911 the American Association of Public Accountants was a somewhat loosely organized body with limited resources, and it did not seem wise to burden it with the responsibility for the detail of business management. Today, however, the situation is quite different and the American Institute of Accountants, successor to the American Association of Public Accountants, is so well organized, so firmly established in reputation and financial strength, that it is manifestly better that all the institute's activities should be centralized.

With this thought in mind the American Institute of Accountants at its last annual meeting resolved that at the termination of the contract in 1922 the institute should take over THE JOURNAL OF ACCOUNTANCY and give the magazine the benefit of direct and united control.

When the action of the institute became known the publishing company expressed a wish to terminate the contract at once. This proposal met with the approval of the executive committee of the institute and negotiations led to a decision to make the change of management beginning with the April issue.

For some time past the magazine has been the victim of irregularity in date of publication and the institute has been almost powerless to prevent such a condition because of the division of control. This number is to be placed in the mails not later than April 11th. The May number is to appear on the first day of the month, and thereafter the date of publication is to be the first unless that day falls on Sunday or a public holiday.

We believe that this summary of our history will be of interest to many of our readers who may not have understood the facts. From today we assume full responsibility for all shortcomings, we promise ourselves great things for the future and, with these few remarks concerning ourselves, we lay down the pen of the autobiographer and trust that the balance of praise due will emanate from our friends.

Income-tax Department

EDITED BY STEPHEN G. RUSK

Solicitor-general Frierson, in arguing before the supreme court in the cases of *Brewster versus Walsh* and *Goodrich versus Edwards,* laid down rules for determining gains or losses on sales of property acquired prior to March 1, 1913, as follows:

(a) There is a taxable profit only when the selling price is greater than cost.
(b) When value on March 1, 1913, is greater than cost, the taxable profit is the difference between such value and the selling profit.
(c) If value on March 1, 1913, is less than cost, the taxable profit is the difference between cost and selling price.
(d) There is a deductible loss only when the selling price is less than cost:
 (1) If value on March 1, 1913, is greater than the cost the deductible loss is the difference between such value and the selling price;
 (2) If value on March 1, 1913, is less than cost, the deductible loss is the difference between cost and selling price.

The department has not made a ruling as yet in conformity with the above rules, and they cannot, therefore, be accepted as final, but these rules are so sensible that it seems probable that the department will not hesitate to adopt them.

It will be remembered that in the Brewster case one of the premises cited before the court was that the complainant had purchased certain stock prior to March 1, 1913, and sold it subsequent thereto at the same price at which it had been purchased; but, as the value on March 1, 1913, was less than cost, the department of internal revenue had claimed there was a taxable profit of the difference between the selling price and the value on March 1, 1913.

Treasury decision 3125 contains a finding of the United States circuit court of appeals for the sixth circuit which has important bearing on the question of depreciation.

There were no other treasury decisions of any general interest during the month elapsed before going to press, but there were several instructive office decisions which are set forth below.

TREASURY RULING

(T. D. 3125, February 2, 1921)

Corporation excise tax—Deduction—Depreciation—Decision in court.

1. DEDUCTION—DEPRECIATION—LOSS IN VALUE OF ROADBED OF RAILROAD.
 No deduction for depreciation in value of the roadway of a railroad may be taken where, because of repairs, renewals, and replacements, the roadway as a whole is as valuable at the end of the taxable year as at the beginning.
2. DEDUCTIONS—DEPRECIATION.
 The depreciation which may be deducted in determining net income is the decrease in intrinsic value due to wear and tear, decay, obsolescence, etc., of the physical property suffered during the taxable year as distinguished from the market value.

3. DEDUCTION—DEPRECIATION—LOSS IN VALUE OF SEPARATE UNITS—APPRECIATION OF OTHER UNITS.

   The roadway must be considered as a whole in determining whether depreciation has been sustained, and the loss in value of separate units of the roadway may be offset by appreciation in other units.

4. EVIDENCE—SUFFICIENCY OF REPAIRS, RENEWALS, AND REPLACEMENTS TO OFFSET DEPRECIATION.

   There was sufficient evidence that the repairs, renewals, and replacements made offset any loss in value, and the roadway had not decreased in value, to justify the trial court in refusing to direct a verdict.

5. RES JUDICATA—LAW OF THE CASE—FORMER APPEAL.

   The decision of this court upon points raised on the former appeal (249 Fed., 678; T. D. 2697) is adhered to.

The appended decision of the United States circuit court of appeals for the sixth circuit, in the case of *Nashville, Chattanooga & St. Louis Railway Co. v. United States,* is published for the information of internal revenue officers and others concerned.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

Nashville, Chattanooga & St. Louis Railway Co., plaintiff in error, v. United States, defendant in error.

[December 7, 1920.]

Before KNAPPEN, DENISON and DONAHUE, circuit judges.

KNAPPEN, circuit judge: This case is before this court a second time. In substance it is this: In June, 1916, the United States, under the direction of its commissioner of internal revenue, brought suit to recover from defendant an excise tax of 1 per cent. claimed to be due from it for each of the years 1909 and 1910, under section 38 of the revenue act of August 5, 1909 (36 Stat., 11, 112, ch. 6), which makes every corporation to which it applies "subject to pay annually" a special excise tax of 1 per cent. on its net income, to be determined by deducting from gross income, among other things, operating expenses, losses sustained, "including a reasonable allowance for depreciation of property," interest on indebtedness, and taxes. The declaration alleged the filing by defendant with the commissioner of internal revenue, on February 25, 1910, and February 21, 1911, respectively, of returns of its net income for the respective years 1909 and 1910; that both returns were incorrect as to the amount of defendant's income, that for 1909, in that it included, as an item of deduction from gross income, an alleged charge of $26,000 to expenses, which was not a necessary expense actually paid out of income in the maintenance and operation of its business and properties; those for both years, in that they included charges to depreciation of roadway amounting to $249,024.54 for the year 1909 and $239,229.70 for the year 1910, which were not charged against the capital valuation of the roadway on its books and were not reasonable allowances for depreciation of roadway within the meaning of the act; that the three items named were disallowed by the commissioner of internal revenue and held by him to be incorrectly charged; and that they were in fact not correct and proper deductions from gross income, and that the total amounts so deducted, which should have been included as net income in said returns, were for the year 1909 $275,024.54 and for 1910 $239,229.70; that the defendant was thus indebted to the United States and subject to pay income tax of 1 per cent. upon the amounts stated; that it had failed and refused to make payment and that the alleged taxes were thus due from defendant and payable by it to the United States.

The railway company demurred to the declaration upon grounds, so far as now important (a) that the government could not recover an excise tax in advance of an assessment by the commissioner of internal revenue, and (b) that the railway company, having made its returns and paid the assessments made by the commissioner, could be made subject to no further obligation unless the commissioner should discover some item to be false within three years from March 1 of the year succeeding the calendar year for which the return is made. The trial court sustained the demurrer. This court reversed that action, and remanded the case for further proceedings and trial (249 Fed., 678). The railway company then pleaded nil debet to each of the two counts of the declaration, together with special pleas to each count, raising the identical questions which had before been presented by its demurrer to the government's declaration. The government's demurrers to these special pleas were sustained by the district court, on the authority of this court's decision. Upon trial by jury there were verdict and judgment against the railway company for $5,142.50, being 1 per cent. upon the amount of the three items in question. This writ is to review that judgment.

1. Upon the present hearing counsel for the railway company in support of its special pleas, overruled below, has again argued at great length the questions presented to and considered by this court under defendant's demurrer to the government's declaration. All of these questions, which relate equally to the special pleas, were, upon careful consideration, decided by this court against defendant's contention. It is unnecessary here to repeat the grounds of that decision, which sufficiently appear from our published opinion (249 Fed., 678). The argument now advanced sheds no additional light upon the subject. We content ourselves with saying that we find no reason to depart from our former conclusions. The assignments of errors numbered 1 to 5, inclusive, are accordingly overruled.

2. The remaining assignments relate to the refusal to direct verdict for defendant, to the charge as given, and to the refusal of certain of defendant's requested instructions. A consideration of the criticisms relating to the charge will aid in determining whether there was a case for the jury.

Defendant conceded on the trial that the deduction of the $26,000 item in its return for 1909 was not authorized. The court accordingly properly instructed that the government was entitled to a verdict for at least $260.00 on this account. The substance of the charge otherwise was that the question of fact to be determined was merely whether the deductions made by defendant in its excise tax reports for the years 1909 and 1910, viz, $249,024.54 for the former year, and $239,229.70 for the latter year, were in whole or in part reasonable allowances for depreciation of roadway during those respective years; that if such allowances were reasonable the government is not entitled to recover; that if they were not reasonable the government was entitled to verdict for 1 per cent. of the amounts improperly deducted. The jury was specifically instructed to consider, first, "the depreciation, either physical or functional, in the value of those parts of the roadway which have not been repaired or renewed or replaced," and, second, "what has been the effect of the repairs, renewals and replacements that have been made to other parts, and determine whether, after you strike a final balance at the end of the year, the roadway is of greater or less value, or of equal value, than or to that which it was at the beginning of the year;" and that if it should be found "that the value of the roadway, its actual value, is as great at the end of the year, after these repairs and replacements have been made for which credit has been given as an expense deduction, then there is no depreciation in value of * * * the roadway, within the meaning of the statute;" but that "if after making such repairs, replacements and renewals in the different units of the roadway it should be found that some parts have been made more valuable by the putting in of new parts in place of worn-out parts, yet the depreciation in the rest of the roadway, in the deterioration, obsolescence, etc., of other units which have not been changed, and so little done in repairing and replacing that at the end of the year, taking it as a whole, the depreciation in value has exceeded the repairs, replacements and renewals, so that it is worth less than it was * * * to that extent the railway is entitled to a deduction of 1 per cent."

The first specific criticism to the charge is that depreciation was made to depend upon the relative value of the roadway "in dollars and cents" at the beginning and end of the respective years. The contention is that the criterion is "earning power," "value for use," not its value to an investor. In point of fact, the court did not use the expression "dollars and cents" in its charge to the jury. Its various expressions were "value," "net value," "actual value," "real value," doubtless meaning intrinsic value, value in "dollars and cents" as distinguished from market value, which defendant's testimony showed might be affected by considerations other than intrinsic value.

The criticism is without merit. Not only is it clear that market value was not meant, but the criticism loses all point through the specific admission of defendant's counsel made upon the trial, that "the road as a whole, for the purpose of carrying on the business of a common carrier, was just as valuable at the end of the year as at the beginning," and by the equally express admission of defendant's chief engineer, not only to the same effect as that of counsel, but, further, that it would be worth as much to "any persons that wanted to buy it for a railroad."

The further criticism is made that "the court refused to permit the jury to consider depreciation, physical or functional, in the units constituting roadway, track, and structures," the argument being that "a railroad is a composite property, it is impossible to figure depreciation of a road as a whole without first considering depreciation of the units."

The court, however, did not instruct that depreciation of units could not be considered in determining the ultimate question whether there was not depreciation in the roadway as a whole. It is true that after stating that there would be no depreciation if repairs, renewals, and replacements had placed the roadway in the same value as at the beginning of the year, it was said: "In that sense you should not consider each of the individual units that enter into the roadway." But the meaning of that statement was made clear by the paragraph immediately following: "It was not intended to have a system of bookkeeping with reference to each particular crosstie or each particular rail, but you should look to the value of the roadway as a whole, comparing its value at the beginning of the year with its value at the end of the year." Further evidence of the meaning of the charge appears from the later use of the term "net value;" also by the earlier reference to the making of repairs, renewals, and replacements in the roadway by "taking out units that had decayed or whose usefulness was at an end and putting in others; taking out crossties, decayed crossties, worthless crossties and putting in new crossties, taking out rails worn out and putting in new rails; repairing and replacing different units in its roadway system from time to time;" as well as by the instruction that the jury should consider "depreciation, either physical or functional, in the value of those parts of the roadway which have not been repaired or renewed or replaced, then also consider what has been the effect of the repairs, renewals, and replacements that have been made to other parts, and determine whether after you strike a final balance at the end of the year the roadway is of greater or less value, or of equal value, than or to that which it was at the beginning of the year."

The contention on which defendant seems to rest its chief criticism seems to be that notwithstanding the roadway as a whole was intrinsically just as valuable at the end of the year as at the beginning of the year, that is to say, although depreciation in given units had been fully overcome by appreciation in others, the railway company would still be entitled to credit for depreciation in such individual units as had depreciated. We think this contention of defendant not sustained by reason or authority, and that the court correctly charged the true criterion. If, as is not entirely clear, it is meant to further suggest that the consideration of functional (as distinguished from physical) depreciation was not allowed by the charge to be taken into account, the suggestion is plainly without merit. Not only did the court define the roadway as including "structures connected with the roadway, such as stations, tool houses and matters of that sort," but it included in depreciation a lessening of original value "due to wear and tear, decay, gradual decline from obsolescence, that is, getting out of date, and inadequacy." In our opinion the jury was given the correct rule for determining the existence or nonexistence of depreciation, which accords with the "ordinary and usual sense" of that term "as understood by business men."—*Van Baumbach v. Sargent Land Co.* (242 U. S., 503, 524). To say that property can depreciate without impairment of either intrinsic value or efficiency is to our minds a solecism.

3. *The refusal to direct verdict.*—The sole question in this regard is whether or not there was substantial testimony tending to support the government's contention that there was during the years 1909 and 1910 no net depreciation in the intrinsic value of the roadway and structures considered as a unit. It is not highly important to the determination of this question whether the controversy arose on one theory and was tried on another, nor whether the claimed depreciation would have been allowed under the system of bookkeeping employed by the government had the charges therefor been set up on the railway company's books (249 Fed., 686).

It appears that defendant arrived at the depreciation charges by estimating the value of the perishable structures as one-third the cost of the road (less equipment and real estate), and then taking 3 per cent. of this one-third value, on the theory that the average life of the various perishable elements was 33⅓ years. Whether or not these depreciation estimates were reasonable was a question for the jury.

In our opinion there was substantial testimony tending to support the government's contention. It appeared that there was expended in round numbers for maintenance of way and structures; that is to say, for repairs, renewals, and replacements for the year 1909, $1,600,000, and for the year 1910, $1,554,000, and that no substantial part of these sums was carried in defendant's accounting as additions and betterments. It was admitted by defendant's chief engineer that the expenditures for 1909 "kept the road in normal condition to carry on its business," that "its normal condition was a good condition," and that the expenditures "had made good the normal amount of depreciation." There was testimony by competent witnesses of railway experience that "there may be depreciation in the units comprising the roadway, track, and structures of the railroad, while there is no depreciation in the machine as a whole;" also that it is possible "to maintain the roadway, track, and structures so that there will be no depreciation if we consider the roadway, track, and structures as a composite whole;" also that "the service life of any normally operated and normally and well maintained railroad is perpetual, and it is maintained in the condition of property serving its purpose by annual renewals and replacements." The testimony, considered as a whole, tended to support the conclusion that the amounts expended by defendant during the years in question for repairs, renewals, and replacements should and would have fully offset the depreciation in the various units, and that the defendant's railway and structures were, as a whole, maintained throughout the years in question in fully as good condition, and were of fully as great intrinsic value, as at the beginning of the respective years. The jury would have been clearly justified in inferring from the testimony of defendant's chief engineer, taken as a whole, that the value of the roadway had not depreciated during the two years in question; in other words, that the repairs and renewals that had been made were of such a character as to leave the road at the end of each year of value equal to that at the beginning of the year. That officer's testimony so impressed the trial judge, who stated his opinion from the evidence that "there is no reasonable deduction for depreciation established." Defendant did not directly controvert the situation so shown. Its chief, if not its only, reliance seems to have been on the proposition that in spite of it all there was inevitable annual depreciation in some of the perishable elements not entirely renewed or replaced, so justifying the contention that for this reason there was depreciation within the meaning of the act, even though the roadway as a whole had not decreased in value. To this argument, as already said, we can not assent. It follows that the trial judge rightfully refused to instruct verdict for defendant.

OFFICE DECISIONS

SECTION 212, ARTICLE 22: Computation of net income. O. D. 803

The following rates have been accepted by the bureau of internal revenue as the current or market rates of exchange prevailing as of December 31, 1920:

London	3.535	(dollars to £ sterling).
Australia	3.55	(dollars to £ sterling).
New Zealand	3.55	(dollars to £ sterling).
Paris	.0590	(cents to franc).
Belgium	.0622	(cents to franc).
Milan	.0347	(cents to lira).
Zurich	.1528	(cents to franc).
Madrid	.1355	(cents to peseta).
Stockholm	.20	(cents to krone).
Christiania	.1535	(cents to krone).
Copenhagen	.1535	(cents to krone).
Amsterdam	.3145	(cents to guilder).
Buenos Aires	.7510	(cents to peso).
Montevideo	.7462	(cents to centavo).
Colombia:		
Bogota	.8620	(Colombian cents to dollars).
Barranquila	.8474	(Colombian cents to dollars).
Cartagena	.8474	(Colombian cents to dollars).
Medellin	.8474	(Colombian cents to dollars).
Lima	4.42	(dollars to Peruvian £).
Bolivia	.277	(cents to bolivianos).
Mexico City	.4925	(cents to peso).
Yokohama	.48	(cents to yen).
Calcutta	.265	(cents to rupee).
Singapore	.42	(cents to Singapore dollars).
Dutch E. Indies	.3145	(cents to florin).
Germany	.01365	(cents to mark).
Poland	.0016	(cents to mark).
Austria	.0024	(cents to krone).
Czecho-Slovakia	.0115	(cents to krone).
Jugo-Slavia	.007	(cents to krone).
Greece	.074	(cents to drachma).
Roumania	.0126	(cents to leu).
Bulgaria	.0115	(cents to lev).
Serbia	.0274	(cents to dinar).
Finland	.032	(cents to markka).
Canada	.86	(cents to Canadian dollar).

SECTION 214(a) 1, ARTICLE 101: Business expenses. O. D. 805
(Also section 215, article 293.)

In addition to his salary as an employee, a taxpayer receives sundry amounts from various periodicals for articles contributed by him. His activities in this respect are sufficiently frequent to constitute his writing a business. Held, that the expenses incurred for information services, magazines, stationery, and supplies used in connection with the production of the articles referred to may be deducted as a business expense, but the cost of books is held to be a capital expense and as such not deductible. There may be taken as a deduction an amount representing depreciation on books, typewriter, furniture, and other equipment of a permanent character in proportion to their use in connection with the production of such articles, providing, however, that no other deduction in respect thereof has been or is being claimed in a return.

In accordance with article 292 of regulations 45, as amended by treasury decision 3101, it is held that when trips are made for the express purpose of securing facts for an article, there may be deducted from gross income the reasonable and necessary traveling expenses, including railroad fares, as well as expenses for meals and lodging in an amount in excess of any expenditures ordinarily required for such purposes when at home.

SECTION 219, ARTICLE 343: Decedent's estate during administration. O. D. 807

In February, 1919, A contracted for the sale of certain land receiving x dollars in cash, the balance of $11x$ dollars to be paid in April, 1919.

A died before April, 1919, and the contract was not completed until August or September of that year, when the deed was passed and possession taken by the purchaser. The question arises as to whether any gain was realized either by A or by his estate.

Since the x dollars received by A prior to his death was mere earnest money to bind the contract, he did not receive taxable income from the transaction, inasmuch as the contract was not consummated during his life.

No taxable gain was realized by the estate because of the transaction. Although the legal title to the land vested in the executor for purposes of administration, the substantial thing that went to the executor was the right under the contract to the unpaid balance of the purchase price in trust for the devisees. It is the value of this right of contract and not the value of the land that should be considered. The basis for determining the gain or loss upon the sale or conversion of property acquired by bequest, devise, or descent, is the value of the property at the death of the testator, or its value as at March 1, 1913, if acquired prior thereto. As the right or contract was in this case valued for federal estate tax purposes for $11x$ dollars, which was the amount received by the estate, there could be no gain or loss to the estate. (O. D. 631; 33-20-1134 modified.)

SECTION 219, ARTICLE 347: Estates and trusts which can not be treated as a unit. O. D. 808

Under a will a trust was created for the period of A's life, a part of the income of which is to be paid to a charitable institution and an educational institution and the remainder to A. At the termination of the trust the property is bequeathed to the charitable and educational institutions. A portion of the trust property was shares of stock. In 1919, the right was given to shareholders to subscribe to additional shares of this stock which right was sold by the trustee.

Held, that the amount received by the trustee from the sale of the right is taxable income, the imposition of the tax not being affected by the fact that the ultimate beneficiaries may be a charitable and an educational institution.

Held further, that the trust can not be treated as a unit for income tax purposes, there being income distributable periodically and also income (according to federal income tax statutes and regulations) which is not distributable periodically under the law of the state in which the testator resided. The amount received from the sale of the right to subscribe for stock is income according to federal income-tax statutes, and under the state law the profit from the sale of the right goes to the remainderman as against the life tenant.

The trustee should file form 1040 returning as income the amount received from the sale of the right which is not distributable periodically and also form 1041 showing the distributive shares of the beneficiaries in that portion of the trust income which is distributable periodically.

SECTION 326, ARTICLE 836: Tangible property paid in; value in excess of par value of stock. O. D. 813

The M Company was organized subsequent to 1919. Soon thereafter it acquired all the capital stock of the N Company by issuing to the stockholders of the N Company its own stock in an amount equal to the par value of their shares of stock. The M Company thereupon by merger absorbed the N Company and became the owner of all the property of the N Company, which consisted of real estate, buildings, machinery and equipment, stock on hand, and work in process. This property had been purchased by the N Company in the same year at a bargain, as shown by an appraisal made of the property about the time it was taken over by the M Company.

Held, that the company could not include in its invested capital as paid-in surplus the excess of the value of the property over the purchase price paid therefor. Any excess resulted from a successful bargain and is not paid-in surplus. Paid-in surplus as used in section 326 of the revenue act of 1918 does not mean the excess value of property purchased in a bona fide sale over the purchase price thereof. To constitute paid-in surplus of a corporation there must, in effect, be a gift to the corporation.

SECTION 212, ARTICLE 25: Accounting period. A. R. R. 391

The committee has had under consideration the appeal of the M Company from the action of the income-tax unit holding that the corporation is liable to file income and profits tax returns on the basis of fiscal years ending October 31, 1918, and 1919, instead of upon the calendar year basis.

It appears from the records in the case that the M Company was organized in July, 1917, as the successor to a corporation of the same name whose fiscal year ended on October 31 of each year. The new corporation adopted such fiscal year as its own and took exact inventories and closed its books on October 31 of each year, which inventories were carried forward as a running book inventory so that figures were available as of the first of each month.

The M Company now states:

> The new corporation on its organization did not request the permission of the department to file upon a fiscal year, and accordingly returns were filed for 1917 and 1918 upon the basis of a calendar year. In preparing the return for the calendar year 1919, however, the company secured the assistance of a firm of accountants who advised them that under the act of 1918 the return should be filed upon a fiscal year, and at their suggestion a letter (dated April 15, 1920) was prepared and sent to the department requesting permission to file for a fiscal year ending October 31. This permission was granted, and accordingly an amended return for the year ending October 31, 1928, was prepared and filed, and a return for the year ending October 31, 1919, was filed.

The company now contends that the accountants were in error in advising it to file returns on the basis of a fiscal year ending October 31; that its original returns were properly filed on the calendar year basis and should be accepted. The corporation frankly states that during November and December of 1918 it suffered a large loss, that during the first 10 months of 1919 it made very large profits, and if its tax is to be determined on the basis of a fiscal year ending October 31 a peculiar hardship to the company will result.

The records further show that in July, 1919 the corporation adopted a new set of by-laws which included the following:

> ARTICLE X. Fiscal year.—The fiscal year of the corporation shall begin on January first and end on December thirty-first in each year.

This case is similar to that covered by committee recommendation 342 except that in the latter the taxpayer changed its accounting period from a fiscal year to calendar year basis prior to the passage of the revenue act of 1918, and closed its books on the latter basis. As has been shown, the M Company did not make such change until July, 1919, subsequent to the passage of the said act.

What was stated in recommendation 342 relative to returns filed on a calendar year basis for years prior to 1918 applies with equal force to the return filed on a calendar year basis for the year 1917 by the M Company. Since, however, that company did not change its accounting period prior to the passage of the revenue act of 1918, and did not formally close its books as of December 31, 1918, it did not fix an annual accounting period on the basis of a calendar year in accordance with the requirements of article 25, regulations 45. As stated in that article:

> A taxpayer having an existing accounting period which is a fiscal year within the meaning of the statute not only needs no permission to make his return on the basis of such a taxable year, but is required to do so, regardless of the former basis of rendering returns.

From date of organization up to July, 1919, the fiscal year of the M Company is established by its by-laws closed on October 31 of each year, exact inventories were taken, and the company's books were formally closed as of that date. No request for permission to change from a fiscal year to a calendar year basis was made by the corporation prior to July 6, 1920, and therefore the committee recommends that the original return filed by the company on a calendar year basis for 1917 be accepted, and that returns to cover the period subsequent to December 31, 1917, be accepted only when filed on the basis of fiscal years ended October 31.

SECTION 213(a), ARTICLE 48: Improvements by lessees M. 2714
(Also section 214(a) 1, article 109.)
(Also section 214(a) 8, article 164.)

INCOME TO LESSOR FROM IMPROVEMENTS ERECTED BY THE LESSEE UPON LEASED GROUND.

Treasury decision 3062, dated September 1, 1920, dealing with the question of the realization of income by a lessor from the erection by the lessee of improvements on leased ground, has been the subject of many inquiries. It is deemed advisable, therefore, to state the reasons for its promulgation and to demonstrate the proper construction of it by application to a specific case.

On February 6, 1917, by treasury decision 2442, the bureau held that where, under the terms of a rental or lease contract, a tenant agrees to erect a building or other permanent improvement, upon the freehold of another, the building or improvements become a part of the realty, and the difference between the cost of the improvements and the allowable depreciation during the lease term is gain or profit to the lessor at the end of the lease term and is to be accounted for as income at that time.

The ruling contained in treasury decision 2442 was adhered to by the bureau and was embodied, with some minor changes, in regulations 33, revised, article 4, paragraph 50, and in regulations 45, article 48. The bureau abandoned this ruling only when forced to do so by the courts. In the case of *Miller v. Gearin*, 258 Fed. 225, the circuit court of appeals for the ninth circuit held that the value of improvements erected upon leased ground by a lessee is not income to the lessor *at the expiration of the term* *of the lease.* A writ of certiorari was sought from the supreme court but was denied. Following this decision came the case of *Cryan v. Wardell,* 263 Fed. 248, reaching the same conclusion. In both of these decisions it is held that the value of improvements erected on leased ground by a lessee is not income of the lessor at the termination of the period of the lease, and it is stated, obiter dictum, that the income, if any, is realized when the buildings or improvements are erected and title passes to the lessor. In *Miller v. Gearin,* supra, the court said:

> The lessor acquired nothing in 1916 (the year of the termination of the lease) save the possession of that which for many years had been her own. It was not a gain but a loss. Assuming that the building was income derived from the use of the property we think it clear that the time when it was "derived" was the time when the completed building was added to the real estate and enhanced its value.

And in *Cryan v. Wardell,* supra, it is stated:

> The right to levy the tax turns upon the question: When did title to this building vest in plaintiff and become a part of her property for the purpose of taxation? I am of opinion that under well-settled principles, aptly expressed in section 1013, civil code of California, the moment the building was erected, which the terms of the lease show was to become and remain an integral portion of the land upon which it was constructed, the title thereto vested as completely in plaintiff as though constructed by the plaintiff herself. * * *. It, therefore, became, upon the completion, a part and parcel of plaintiff's income-bearing property, and was subject to taxation in her as of that date.

As a result of these decisions, the office modified its prior rulings on the subject, and T. D. 3062 was accordingly promulgated.

The adoption in T. D. 3062 of the view occasioned by the above-cited decisions, that the value of improvements erected on leased ground by the lessee is income to the lessor upon the passage of title, raised the further question as to the measure of the income to be returned by the lessor.

Although the lessor has acquired title to the improvements upon their erection by the lessee, yet it is obvious that the lessor has not received their full value, as measured by an unrestricted dominion over them, inasmuch as his proprietorship is subject to the exclusive right of the lessee to their possession and use during the term of the lease. In recognition of this point it is held in T. D. 3062, that the lessor must include in gross income for the year in which title passes the depreciated value of the improvements —that is, he includes in gross income the estimated present value to him of the improvements, the possession and enjoyment of which is postponed until the termination of the period of the lease. To compute this depreciated value, the value of the land free from the lease without the improvements is subtracted from the value of the land subject to the lease and with the improvements. Inasmuch as the lessor has included in income only the depreciated value of the improvements, in effect taking his depreciation deductions in advance, he is entitled to no depreciation deduction with respect to such improvements until the expiration of the term of the lease when he gains the possession.

The following example is given to illustrate the proper construction to be given to T. D. 3062:

A, in 1915, leases certain land to B for 20 years. B agrees, in part consideration for the lease, to erect on the leased ground a building, specifications agreed upon, of an estimated life of 25 years and to cost $50,000, which building is not to be subject to removal by B. The building is completed in 1920.

A realizes income in 1920, the year in which title to the building passes. The measure of the income is the present value to A of the building, of an estimated life of 25 years and cost of $50,000, the use and enjoyment of which is postponed for 15 years. The depreciated value of the building at the termination of the period of the lease will be approximately \$20,000—that is, cost less depreciation sustained. The income of A, then, is the discounted value of \$20,000 receivable at the end of 15 years. If market value reflects intrinsic value, this amount should equal the difference between the value of the land free from the lease without the buildings and the value of the land subject to the lease with the building. However, any other evidence available should be considered in determining this present worth to the taxpayer of the legal title to the encumbered building. Since A has included in income only the depreciated value of the building, he is entitled to a depreciation deduction with respect to such building only for the years after the termination of the period of the lease when A has come into possession. This depreciation deduction to which A is entitled for 1935 and subsequent years should be computed on a basis of the estimated remaining life of the building and a "cost" value equal to the market value placed on the encumbered building by A in the year of its erection, i. e., the annual depreciation deduction for 1935 and subsequent years will be the quotient obtained by dividing (a) the value of the improvements to A as determined by him when the same completed became part of the realty, by (b) the number of years in the estimated remaining life of the improvements from the termination of the lease.

In any case in which the term of the lease is greater than the estimated life of the improvement no income should be accounted for by the lessor at the time of the passage of title. Also if the improvements will have no value at the termination of the lease, as is often the case in mining leases, no income is realized by the lessor.

SECTION 214(a) 8, ARTICLE 163: Depreciation of intangible property. O. D. 818

In the case of liquor dealers the useful life of whose intangibles such as good will, trade-marks and trade brands, was definitely limited as a result of prohibition legislation, an allowance for obsolescence is permissible. However, in the case of dealers who continued in a similar trade or business, the useful life of such intangibles is not definitely limited, although the profits may have been reduced. Therefore, liquor dealers who continued in a similar trade or business can not obtain a deduction under section 214(a) 8 on account of obsolescence of their good will, trade-marks and trade brands.

SECTION 326, ARTICLE 841: Surplus and undivided profits: limitation of additions to surplus account. A. R. R. 394

Recommended that a corporation which issued bonds at a discount in January, 1900, and elected then to charge such discount to profit and loss for the year of issue and the next two succeeding years, may not now revise its accounts and file amended returns for the purpose of reinstating to invested capital the unexpired portion of such discount and claiming as a deduction from income that portion applicable to each year.

It appears from the records that the M Company issued bonds on January 1, 1900, to the amount of $70x$ dollars at a discount of $7x$ dollars and charged such discount to profit and loss in 1900, 1901, and 1902.

The accountants writing in behalf of the corporation stated that it was their understanding that for the purpose of computing net income the case was covered by article 544(3) (a) of regulations 45. The M Company in its appeal contends, in effect, that it did not follow good accounting practice in charging off the discount in question to profit and loss during the years 1900, 1901, and 1902; that recognized accounting authorities, some of whom are named and quoted, hold that discount on bonds issued should be spread over the term of the bonds and the installments thereof charged against income each year, and that, under article 544, it did not have an option of treating all of such discount as interest expense at the date of issuance of the bonds.

Article 544(3) (a) of regulations 45, reads:

> If bonds are issued by a corporation at a discount, the net amount of such discount is deductible as interest and should be prorated or amortized over the life of the bonds.

The unit, in its reply of June 30, 1920, contended that article 544(3) (a) must be considered in connection with article 841, which latter article, bearing the caption "Surplus and undivided profits: limitation of additions to surplus account," provides, in part, that deductions which have been taken from income and which are as a matter of good accounting to some extent optional, such as experimental expenses, patent litigation, development of good will through advertising or otherwise, can not be reinstated in surplus, as in such cases it is considered that the corporation has exercised a binding option in deducting such expenses from income, and an election of this sort which was made concurrently with the transaction can not now be revised and amended returns in respect thereto can not be accepted.

The solicitor of internal revenue, in a memorandum dated May 13, 1919, commenting on a ruling in a case similar to the one under consideration, stated:

> It appears that the corporation in this case had an option as to the method it would adopt in handling entries of the discount on the bonds which it issued. Two methods were available:
>
> First. To treat the discount as interest paid in advance to be amortized over the life of the bonds.
>
> Second. To charge the discount as a loss in its profit and loss account.
>
> The corporation exercised its option by adopting the second method. It did so apparently to lessen its income for the year the transaction took place. It now seeks to adopt the first method and desires to amend its 1917 return accordingly. The effect of this procedure would be that the discount item would be taken from the losses (profit and loss account), thus diminishing the losses and thereby increasing its surplus account, and indirectly its invested capital.
>
> Where a corporation has exercised an option as to accounting practice and such option was concurrent with the transaction, amended returns are not permissible. See article 841 of regulations 45.

While the committee is in accord with the contention of the M Company that it did not follow the more generally approved accounting method in charging off the discount on its bonds of January 1, 1900, as it did, that fact alone does not entitle it now to adopt another method and adjust its accounts for the purpose of filing amended income and profits tax returns. There were at the time said bonds were issued no income-tax regulations prescribing a method to be followed in the treatment of bond discount. It was entirely optional with the taxpayer as to the method it would adopt in handling entries of discount on bonds issued, and inasmuch as that option was exercised at the time the bonds were issued a different method of accounting can not now, in the opinion of the committee, be adopted for tax purposes, which opinion is sustained by the decision in the case of the *C. & A. Railroad v. United States Court of Claims* (see article 149, regulations 33, revised, issued under the provisions of the revenue act of 1916, as amended by the revenue act of 1917).

The committee, therefore, recommends that the ruling of the unit be sustained.

Students' Department

EDITED BY H. A. FINNEY

AMERICAN INSTITUTE EXAMINATIONS, NOVEMBER, 1920

In regard to the following attempt to present the correct solutions to the questions asked in the examination held by the American Institute of Accountants in November, 1920, the reader is cautioned against accepting the solutions as official. They have not been seen by the examiners—still less endorsed by them.

COMMERCIAL LAW

ANSWERED BY JOHN C. TEEVAN*

NEGOTIABLE INSTRUMENTS

Answer three of the following four questions:

1. Is the following a negotiable instrument?

Boston, Mass., July 1, 1920. One year after date, for value received, the Y. Z. corporation promises to pay to the order of Adam Brown three thousand dollars with interest at the office of the Y. Z. corporation, Boston, Mass., or, at the option of the holder hereof, upon the surrender of this note to issue to the holder hereof in lieu thereof thirty shares of the preferred stock of said Y. Z. corporation and to pay to the holder hereof in cash the interest then due upon said sum. The Y. Z. corporation, by Y. Z., President.

Answer:

This instrument is a negotiable promissory note. It is an unconditional promise to pay a sum certain in money at a fixed future time to the payee's order. The inclusion of a promise to issue stock to the holder of the note, at his option, in lieu of the sum of three thousand dollars with interest, does not prevent the maker's promise from being construed as being a promise to pay a sum certain in money. The option is with the holder, not the maker. This point is directly covered by section 5 of the negotiable instruments law which provides that "the negotiable character of an instrument is not affected by a provision . . . which gives the holder an election to require something to be done in lieu of payment in money." Nor does the fact that the payment of interest is promised, and no rate stipulated, render the sum uncertain. Section 2 of the negotiable instruments law states that "the sum payable is a sum certain . . . although it is to be paid with interest." In the absence of a stipulated rate the legal rate of interest applies.

2. What is the effect of endorsement of a negotiable instrument
   (a) by an infant?
   (b) without consideration, by a corporation?

Answer:

(a) Section 22 of the negotiable instruments law provides that the endorsement of a negotiable instrument by an infant passes the property

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therein, i. e., passes the title to the transferee or endorsee. Such endorsee has the right to enforce payment from all parties prior to the infant endorser. In other words the prior parties cannot avail themselves of the incapacity of the infant. But the infant's endorsee is not a bona fide holder as against the infant. The latter may disaffirm (as he may any contract except for necessaries) and thereafter there can be no recovery by his endorsee or any subsequent endorsee. Payment by the maker to the endorsee does not protect the maker. Once the infant has disaffirmed he may recover on the instrument. Briefly, the endorsement of an infant passes title, but the infant may disaffirm.

(b) The endorsee gets a good title to the instrument, but the corporation incurs no liability thereon as an endorser. Section 22 of the negotiable instruments law provides that "the endorsement . . . of the instrument by a corporation . . . passes the property therein, notwithstanding that from want of capacity the corporation . . . may incur no liability thereon."

3. A sold his automobile to B, warranting it to be a 1918 model in good mechanical condition. B gave A his note in payment of the purchase price, of which note C became the holder in due course. B, after a few days, found that the automobile was a 1917 model and in such defective condition that its actual value was but a small proportion of the purchase price paid by him, of all of which X had knowledge. X subsequently purchased the note from C. Could he enforce the note against B?

Answer:

X derived his title to the note from C, who was a holder in due course. Assuming that X was not a party to the fraud practised by A on B, the maker, his (X's) knowledge of the fraud is immaterial. X takes the same title as his transferor, C, had. C being a holder in due course, A's fraud could not be raised as a defense by B against C. X, being the transferee of C, stands exactly in the same position as C and can enforce payment of the note by B. This point is covered by section 58 of the negotiable instruments law.

4. How may a "qualified endorsement" be made and what is the effect of such an endorsement?

Answer:

A qualified endorsement is made by adding the words "without recourse" to the signature of the endorser. This qualification has no effect on the negotiability of the instrument, and so the instrument may be negotiated subsequently with the same freedom as though not so endorsed. The contract of a qualified endorser is covered by section 65 of the negotiable instruments law, under which such endorser warrants (1) that the instrument is genuine; (2) that he has a good title to the instrument; (3) the capacity of all prior parties; and (4) that he knows of nothing which would impair the validity of the instrument or render it valueless. Thus, for example, he does not warrant that the maker is solvent, but if the maker were an infant or otherwise incapacitated he would be liable under warranty number 3.

CONTRACTS

Answer both the following questions:

5. A entered into the following agreement with the R. S. Cement Company:

> "Memorandum of agreement made this 6th day of July, 1905, between A, first party, and R. S. Cement Company, second party, to wit, first party agrees to give the 'R. S.' brand cement the preference in his sales of cement for the year 1905, and in consideration thereof, second party agrees to sell said brand of cement to the first party during the year 1905 at the price of 95 cents a bbl. f. o. b. Haverstraw, New York."

A ordered several shipments of cement which were duly delivered and paid for. Subsequently the market price for cement rose and the cement company notified A that it would furnish no more cement under the agreement. A then purchased his cement elsewhere during the remainder of the year at higher market prices, and he sought to recover from the cement company as damages the difference between the cost of the cement purchased by him at the prevailing market price and what the cement would have cost at the price provided in the agreement. Could he recover?

Answer:

A cannot recover. This agreement is void, and so without legal effect, on three grounds: (1) A's promise is uncertain and indefinite. No limit is placed on the amount of cement that A might order during the year. Nor is there any method provided for in the agreement by which the quantity can be made certain. (2) The agreement lacks mutuality. A is not bound thereunder to sell to his customers or order from the company any cement, but the R. S. Cement Co. is bound to sell to A. The rule is that both parties to a contract must be bound, or neither is bound. (3) There is no consideration on the part of A. He is under no obligation to purchase any cement from the company and has therefore sustained no legal detriment.

6. Define
   (1) a joint contract.
   (2) a joint and several contract, and point out the rights of the respective parties under each.

Answer:

(1) A joint contract is one in which a promise is made by two or more promisors, who, by the provisions of the contract, are jointly bound to carry out such promise, or one in which a promise is made to two or more promisees who are jointly, but not severally, entitled to require performance of such promise. In the case of the failure of joint promisors to fulfill their joint obligation, the promisee must sue them all jointly. If the promisee releases one joint promisor, he thereby releases all the other joint promisors. If one joint promisor dies, the liability survives to the surviving joint promisor or promisors. In the case of a breach of a promise made to joint promisees, such joint promisees must sue the promisor jointly. They cannot bring separate suits against him. If one joint promisee dies, the right of action is in the survivors.

(2) A joint and several contract is one by which, not only all the promisors are liable together or jointly, but each promisor is liable severally. In other words, the promisee in a joint and several contract may choose to hold all the promisors jointly bound to fulfill their obligations to

him or may choose to hold any one of the promisors individually liable. A contract cannot be joint and several as to the promisees.

The foregoing are the common law rules and have been greatly modified by statute in the various states.

Corporations

Answer both the following questions:

7. In what circumstances are directors of a corporation authorized to declare dividends, and what are the liabilities of directors for declaring an unauthorized dividend?

Answer:

The authority of the directors to declare dividends is subject to the provisions, if any, in the charter or by-laws of the corporation regulating this matter and is subject further to any existing statutory provisions. Subject to such provisions, and in any event, the directors may declare dividends only out of net profits or surplus. Ordinarily and in the absence of such restrictions as above indicated, the directors have a large discretionary power as to whether they will or will not declare dividends. If such discretionary power is exercised in good faith, the courts will only in the most exceptional cases compel a declaration of dividends at the request of the stockholders.

If there are no profits or surplus, or if the corporation is insolvent, a declaration of dividends by the directors is illegal, and the directors would thereby render themselves personally liable to the creditors of the corporation to the extent to which the capital stock is thereby impaired. In some states, such action on the part of the directors would also render them guilty of a misdemeanor and subject to fine or imprisonment or both.

8. The X corporation owns certain personal property of which B has wrongfully taken possession. A owns all of the stock of the X corporation and brings in his own name an action to recover the property from B. Is A entitled to recover?

Answer:

A cannot recover in this action. The property wrongfully held by B belongs to the X corporation, not to A, and the fact that A owns all of the stock of the corporation does not vest A with the title to this property. A corporation is an artificial person, a legal entity, separate and distinct from the stockholders, and remains such even when all the stock is held by one person, as in this case. To effect a recovery of the property in question, the action must be brought in the name of the X corporation and no other.

Partnership

Answer one of the following two questions:

9. A, B, and C form a partnership, each by mutual agreement contributing equally to the original capital. Later C furnishes various further sums to the partnership to prevent financial difficulties, the partnership finally being obliged to make an assignment for the benefit of its creditors. What are C's rights with regard to the additional sums furnished by him?

Answer:

Had the partnership remained solvent, the advances made by C would have been repaid to him in the ordinary course of events. Or, if the firm had been dissolved while some assets remained, C would have been entitled to the return of his advances, prior to any distribution of the original contributions to the three partners. In the case in point, however, C's advances, together with the original contributions, were all absorbed in losses or in payment of firm debts. C therefore paid more than his share of the partnership indebtedness to the extent of his advances. He is accordingly entitled to contribution from A and B. As the three partners shared in the profits or losses equally, having contributed equally to the original capital, and no mention appearing of any other basis of sharing profits or losses, A and B are each liable to C for one-third of the additional sums advanced by C. It should be added that, as a general rule, one partner cannot recover by way of contribution from his co-partners for advances or loans made by him to the partnership unless there has been a judicial accounting and settlement of the partnership affairs.

10. C is admitted as a partner in a partnership composed of A and B on contributing a certain amount to the partnership capital. Prior to C's admission, the partnership of A and B incurred a large obligation which subsequent to C's admission as a partner the partnership assets were insufficient to satisfy. A and B having no financial responsibility, X seeks to satisfy his claim out of the individual assets of C. Can he succeed?

Answer:

X cannot succeed. An incoming partner is not liable in the absence of an agreement to that effect, express or implied, for pre-existing partnership debts. The presumption is against such agreement.

This is the common law rule.

Section 17 of the uniform partnership act (now in force in Idaho, Illinois, Maryland, Michigan, New Jersey, New York, Pennsylvania, Tennessee, Wisconsin and Alaska) provides that "a person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before his admission as though he had been a partner when such obligations were incurred, except that this liability shall be satisfied only out of partnership property."

In the case given, however, X seeks to satisfy his claim out of C's individual assets. As above indicated, this cannot be done, either at the common law or under the statute.

Bankruptcy

Answer the following question:

11. On examining the books of the Y corporation you find a judgment in favor of the corporation against A for $1,000.00 recovered on December 10, 1919. You also find that on July 16, 1920, A filed a voluntary petition in bankruptcy showing assets (both real and personal property) amounting to several thousand dollars and liabilities consisting, in addition to the judgment, of amounts due on various promissory notes and open accounts. How would you treat the judgment in preparing a financial statement for the corporation?

Answer:

It is shown here that A's assets consist of both real and personal property. It is a general rule, and the statutes in the several states so provide, that a judgment shall be a lien on the judgment debtor's real estate from the time it is rendered. Section 67f of the bankruptcy act provides that judgment liens obtained or created within four months prior to the filing of a petition in bankruptcy by or against the judgment debtor are dissolved by the adjudication of such person to be a bankrupt. This is equivalent to a provision for the preservation of such liens obtained prior to the four months' period. The judgment secured by the Y corporation against A was rendered more than six months before A filed his petition. The lien of the X corporation on A's real estate is therefore not affected by the bankruptcy proceedings. The other indebtedness of A is shown to consist only of promissory notes and open accounts. These are unsecured claims, over which a judgment lien takes precedence. The judgment in question, therefore, to the extent that A's real property is worth up to $1,000, is a good asset and should be so shown on the financial statement of the Y corporation.

Federal Income Tax

Answer the following question:

12. In 1909 A and B formed a corporation for the purpose of conducting the business then carried on by them under a partnership, each taking equally shares of the capital stock. B died on June 1, 1917, bequeathing his shares of stock to his son Z by will. Because of B's death the corporation ceased active business and began to liquidate. From time to time assets were disposed of and dividends were declared and paid from the moneys received. What is the status of such dividends for federal income-tax purposes

(1) as regards A?
(2) as regards Z?

Answer:

(1) As regards A, it would be first necessary to determine the value of his stock on March 1, 1913. To the extent that the liquidation dividends exceeded this value, the excess would be treated as taxable income for the taxable period in which the last of the liquidation dividends were received by A. If, on the other hand, these dividends fell below the value of the stock on March 1, 1913, the difference would constitute a valid deduction in A's favor.

(2) As regards the status of the liquidation dividends received by Z for tax purposes, they would be treated in the same way as the proceeds received by Z would have been treated if he had sold his stock. That is, the value of the stock should be determined as of June 1, 1917, when it came into Z's possession as a legacy from his father B. If the total liquidation dividends received by Z exceeded the value of the stock as of June 1, 1917, the excess would be taxable income, returnable for the taxable period in which the final dividend was received. If the total liquidation dividends were less than the value of the stock on June 1, 1917, the difference could be shown as a deduction by A in his return.

Income Tax and Employees' Bonus

Editor, Students' Department:

Sir: In preparing the final statements and the income-tax return of the business where I am employed, I am confronted by one of those difficult bonus questions. The business is an individual proprietorship; and at the beginning of 1920 the proprietor engaged a manager agreeing to pay him a stated salary and in addition a bonus based on the increase in the profits of 1920 over the profits of 1919. The profits of 1919 were $6,760.23 after paying the income tax. This year the profits are $19,638.92 before deducting the bonus and before deducting the income-tax. The bonus is to be 10 per cent. of the increase in profits after considering both the tax and the bonus as expenses, and in computing the tax it will of course be necessary to deduct the bonus from the profits of $19,638.92 to find the taxable net profit. It is agreed between the proprietor and the manager that in computing the tax, which shall be treated as an expense in computing the bonus, no personal exemptions shall be allowed and income from other sources shall be ignored. Will you please explain how to compute the bonus and the tax?

Yours truly,

Chicago, Illinois. H. R.

The method of computing the bonus and the tax will depend on whether or not the bonus is large enough to bring the taxable profits below $18,000.00, because if the profits after deducting the bonus are in excess of $18,000.00 there will be a surtax at 8% on the amount between $18,000.00 and $20,000.00, but if the taxable profits are less than $18,000.00, the highest surtax rate will be 7%. It can be determined by inspection that the profits after deducting the bonus will be in excess of $18,000.00.

The profits for 1920 before deducting the bonus were...	$19,638.92
The profits for 1919 were	6,760.23
Excess	$12,878.69

If this entire difference were subject to the 10% bonus, the bonus would be $1,287.87 and the taxable profits would be $19,638.92 minus $1,287.87, or $18,351.05. But as the bonus will be less than $1,287.87, the taxable profits will be more than $18,351.05. Having established the fact that there will be a surtax at the 8% rate, the solution can be performed as follows:

The tax on $19,638.92 would be:

Normal tax:		
4% of $4,000.00		$160.00
8% of 15,638.92		1,251.113
Surtax:		
1% of $1,000.00	10.00	
2% of 2,000.00	40.00	
3% of 2,000.00	60.00	
4% of 2,000.00	80.00	
5% of 2,000.00	100.00	
6% of 2,000.00	120.00	
7% of 2,000.00	140.00	
8% of 1,638.92	131.113	681.113
Total tax		$2,092.23

The bonus will reduce the profits subject to the normal tax at the 8% rate and also the profits subject to the surtax at the 8% rate. If the bonus is represented by x,

True tax = $2,092.23 — .08x — .08x
= $2,092.23 — .16x

Since the bonus is 10% of the difference in profits ($12,878.69) minus the tax and minus the bonus,

$$x = 10\% \ (\$12{,}878.69 - \text{tax} - \text{bonus})$$
$$x = 10\% \ [\$12{,}878.69 - (\$2{,}092.23 - .16x) - x]$$
$$x = 10\% \ (\$12{,}878.69 - \$2{,}092.23 + .16x - x)$$
$$10x = \$12{,}878.69 - \$2{,}092.23 + .16 - x$$
$$10x - .16x = \$12{,}878.69 - \$2{,}092.23$$
$$10.84x = \$10{,}786.46$$
$$x = \$995.06 \text{ the bonus}$$

Proof

Profits before bonus	$19,638.92
Less bonus	995.06
Taxable profit	$18,643.86

Computation of tax

Normal:	
4% of $4,000.00	$160.00
8% of 14,643.86	1,171.508
Surtax:	
10 + 40 + 60 + 80 + 100 + 120 + 140 =	550.00
8% of $643.86	51.508
Total tax	$1,933.016

Computation of bonus

Difference in stated profits		$12,878.69
Less: Tax	$1,933.02	
Bonus	995.06	2,928.08
Basis of bonus		9,950.61
Bonus = 10% thereof (as above)		995.06

As pointed out in the beginning of this answer, the method of computing the taxable profits, the tax and the bonus will depend on whether the bonus is sufficiently large to reduce the taxable profits below $18,000.00 or not. If the profits had been reduced below $18,000.00, the solution would have been as follows, assuming these facts:

Profits, 1920, before tax and bonus	$18,500.00
Profits, 1919, after tax	6,500.00
Difference	$12,000.00

Let x represent the amount by which the taxable profits are reduced below $18,000.00.

Then taxable profits = $18,000.00 — x
And the bonus = $500.00 + x

The tax on \$18,000.00 would be:

Normal:		
4% of \$4,000.00		\$160.00
8% of 14,000.00		1,120.00
Surtax:		
At 1%	\$10.00	
2%	40.00	
3%	60.00	
4%	80.00	
5%	100.00	
6%	120.00	
7%	140.00	550.00
Total tax		\$1,830.00

The reduction of the profits to \$18,000.00 — x, will reduce the tax by 8% of x (being the normal tax rate) and also by 7% of x (being the surtax rate on the profits between \$16,000.00 and \$18,000.00).

Hence the tax on \$18,000.00 — x = \$1,830.00 — .08x — .07x

The bonus = 10% (\$12,000.00 — tax — bonus)

Hence \$500.00 + x = 10% [\$12,000.00 — (\$1,830.00 — .08x — .07x) — (\$500.00 + x)]

\$500.00 + x = 10% (\$12,000.00 — \$1,830.00 + .15x — \$500.00 — x)

\$5,000.00 + 10x = \$12,000.00 — \$1,830.00 + .15x — \$500.00 — x

10x — .15x + x = \$12,000.00 — \$1,830.00 — \$500.00 — \$5,000.00

10.85x = \$4,670.00

x = \$430.41

Then the bonus = \$500.00 + x = \$500.00 + \$430.41 = \$930.41

Proof

Net profit, 1920, before tax and bonus	\$18,500.00
Less bonus	930.41
Taxable net profit	\$17,569.59

Computation of tax

Normal:	
4% of \$4,000.00	\$160.00
8% of 13,569.59	1,085.567
Surtax:	
10 + 40 + 60 + 80 + 100 + 120 =	410.00
7% of \$1,569.59	109.871
Total tax	\$1,765.44

Computation of bonus

Increase in profit		$12,000.00
Less: Tax	$1,765.44	
Bonus	930.41	2,695.85
Basis of bonus		9,304.15
Bonus = 10% thereof (as above)		930.41

Corporate Transactions and Stockholders' Transactions

Editor, Students' Department:

Sir: I shall be glad if you will please give an opinion on the following question:

A group of individuals purchased 90% of the capital stock of a corporation from an individual who retired from the business. They paid him a bonus of $50,000 over and above the book value of the assets acquired, such bonus having been expressly stipulated as a payment for the goodwill of the former owner. The corporation remained intact and continued to operate under the original charter and name without increase of capital stock.

What entry should be made on the books of the corporation properly to reflect the investment of the purchasing stockholders of the goodwill?

Does the investment of $50,000 for goodwill constitute an increased invested capital of the corporation for federal profits tax purposes?

Yours very truly,

Fort Worth, Texas. J. R. M.

No entry should be made on the corporation's books. The corporation is not a party to the transaction; hence the corporation's books cannot be affected by it. If it were proper or necessary to reflect the payment for goodwill on the corporation's books because of this transaction, it would be equally proper and necessary to make an entry in the general books of the corporation every time an individual stockholder sold his stock to another individual and to reflect in the corporation's goodwill account the difference between the par of the stock sold and the price paid. The fact that the purchasing parties stipulated that the $50,000.00 was paid for the goodwill of the former owner of the stock does not make the transaction a purchase of the goodwill on the part of the corporation.

Money in Oil

Editor, Students' Department:

Sir: An oil and gas company was incorporated in May, 1909, with 24,000 shares at $1.00 each. All shares were issued as of that date but no money was received for stock nor was entry made. Leases were bought for $1,288.00 but were conservatively valued, in my opinion, at $6,288.00. This excess of $5,000.00 was credited to capital and charged to lease account. I corrected this entry by crediting capital stock with $24,000.00, charging capital stock deficiency with $19,000.00 and leases $5,000.00. In the year 1914 the company accumulated a surplus allowing for depreciation sufficient to wipe out this $19,000.00 deficit; therefore I charged surplus $19,000.00 and credited capital stock deficiency a like amount. When depletion is set up the surplus will show a deficiency at close of 1914. The business shows a loss for every year thereafter allowing for depreciation and depletion.

On April 16, 1917, the company borrowed $12,000.00 endorsed by two new officers and the old president. The company paid all old claims and notes and used the balance to buy the outstanding stock of 24,000 shares—17,333⅓ shares at 15 cents and 6,666⅔ shares at 33 cents. The old president owned 6,666⅔ shares, and he rėceived 15 cents a share or $1,000.00. The stock was then reissued without any consideration to the three endorsers of the $12,000.00 note. The entry was to credit notes payable with $12,000.00 and charge the bank $12,000.00. Then for the $4,800.00 in cheques written for the stock at .15 and .33, the bank was credited and stock account was charged. The journal entries were as follows: debit investment $4,800.00, credit stock sales $4,800.00. The charges to stock account and above journal entry are, of course, errors. I corrected these entries, charging treasury stock with the par value of the stock, $24,000.00, crediting the bank $4,800.00 and surplus $19,200.00.

The stock was reissued to the three endorsers of the $12,000.00 note (and two others one share each) without any consideration. For this I charged capital stock deficiency and credited treasury stock $24,000.00 each. I then charged surplus and credited capital stock deficiency with $24,000.00 each. The corporation at the close of 1920 will show a deficit of about $20,000.00, after allowing for depreciation and depletion, with one year's depreciation and depletion necessary to wipe out the investment accounts—buildings and power plants, tanks, pipe and fittings, leases, drilling and shooting. Of course there is still quite an equity in these accounts even though closed through depreciation and depletion.

A contract was made to sell the company in 1919 and $2,447.00 was paid. This was credited to capital in error, and I corrected entry, crediting the purchasing company. Purchasing company has not fulfilled its contract in this company's opinion, yet the purchasing company asks for a return of its money. As soon as it is decided, we shall return all or part or shall credit this balance to surplus. Another agreement has been made to sell the company to a larger corporation for $20,000.00 and $10,000.00 has been paid. I have credited this to the purchasing company. Later when the full amount shall have been paid, the stock will be issued to the holding company and I suppose surplus will be credited with the $20,000.00. Perhaps I should have left the capital stock deficiency of $24,000.00 open in 1917 and should credit this account now with the $20,000.00 when received and charge surplus with the difference.

I would like to have your opinion on my entries together with criticisms and corrections, if it is not asking too much.

Yours truly,

C. H. S.

Some time ago, in conversation with a petroleum engineer, I was informed that the capitalization of the companies organized to exploit the oil fields of a certain district in one of the southern states greatly exceeded the value of the apparent oil supply in that district. He cited these statistics to prove that investors in oil companies would never get back their money. Apparently he was not familiar with the methods of finance and accounting described in your letter.

When the stock was issued it would seem that honesty would require an entry debiting deficit and crediting capital stock $24,000.00. When the leases were acquired they should have been put on the books at their cost, $1,288.00, and they should not have been written up, regardless of their value. I am a little curious about the source of the money to pay for the leases—perhaps they were purchased on account. It is hard to believe that the stockholders put in the money.

The charge to lease and credit to capital, $5,000.00, was, of course, wrong. Your entry does not correct it. You leave the accounts, at that point, with a debit to capital stock deficiency (deficit) of $19,000.00, a debit to leases of $6,288.00 and a credit to capital stock of $24,000.00. The debit to deficit should be $24,000.00 and the debit to leases $1,288.00.

Closing the surplus of $19,000.00 which arose from earnings by crediting it against the deficit account was correct; but there would have been a $5,000.00 balance remaining in the deficit account if the leases had not been improperly written up.

Endorsing a corporation's notes so that the company can borrow money to buy the stockholders' stock and give it back to them is an ingenious method of paying a dividend when the company has no surplus and no cash. You have corrected the erroneous entry made to record this transaction, and you have the right idea about the treatment of the amounts paid by the various parties who have entered into contracts for the purchase of the company. However, as to crediting surplus with the total amount paid by the latest purchaser, it would seem to me that you ought to credit the assets sold if there are any.

I should be interested in knowing the outcome of these two contracts to sell the company. The situation seems a little complex.

Correspondence

Profit on Sale of Investments

Editor, The Journal of Accountancy:

SIR: I have read with considerable interest your editorial in the January issue of THE JOURNAL OF ACCOUNTANCY in regard to the federal decision of *Brewster v. Walsh,* which holds that profits realized from the sale of investments or capital assets are not income and therefore not taxable under the sixteenth amendment of the constitution.

I have also read with renewed interest, in your February issue, opposite views regarding the question from Mr. John Bauer and Mr. George O. May.

As this federal decision is of vital importance to the business world, I presume public accountants have given the matter more or less consideration and are expressing their views on the one side or the other.

Like the question of interest on investment, it will be impossible to obtain unanimity of opinion from accountants on this question, and the only thing that can be expected is the presentation of the process of reasoning leading to their different conclusions.

My point of view coincides with Mr. Bauer's rather than with Mr. May's. As Mr. Bauer points out, if A owns real estate costing $100,000.00 on which he earns $8,000.00, he is complying with the law when he pays a tax on $8,000.00 because this amount is *income* on his investment. If his real estate appreciates in value to $200,000.00 on which he subsequently earns $16,000.00 and he pays a tax on $16,000.00 he is still complying with the law because $16,000.00 is his income or return on his investment. Now if A sells his real estate later for the appreciated amount of $200,000.00 and pays a tax on the appreciation of $100,000.00 he is certainly paying a tax on *capital* instead of on *income.* It is obvious that there is an increment of $100,000.00, but we must discriminate between increment arising from capital increases, which we will call capital increment, and that arising from the use of capital, or revenue increment.

Mr. May states that if increments of capital are in no circumstances income, decrements of capital cannot be allowed to enter into the computation of income, and therefore depreciation on machinery used in production would not be a proper deduction. In my opinion the two cases are not parallel. Nearly all capital necessary to be invested in an enterprise for operating returns is in a larger sense an expense. This is true whether the capital is used as working capital to pay for operating labor, to purchase operating supplies, or is invested in buildings or machinery.

The only difference is that labor and supplies become almost immediately a current operating expense, while the capital invested in machinery and buildings has to be absorbed through operation periodically in the form of depreciation. In other words these diminishing assets must be charged against operation to find correct costs on which to compute net income. However, if capital assets actually increase in value, actually increase the investment of the business beyond the original amount, is not this a capital accretion? What has it to do with revenue? It increases the net worth of the business, but the net worth may be increased through capital accretions as well as through revenue accretions, and logically only revenue or income accretions should be taxable. This is fully recognized in the fact that the capital stock of a corporation sold by the corporation at a premium is not taxable, because it is a capital accretion. This is fully realized by all practising accountants when in corporation accounting they endeavor to differentiate between capital surplus and revenue surplus on the books of the corporation, as well as on their balance-sheets.

Let us take another example. Suppose a business man be so shortsighted as to be without fire insurance on his plant, and it takes fire and becomes a complete loss. Or suppose a company operating a fleet of vessels carried no insurance against losses by storm, etc., and they foundred. Logically, these must be considered capital losses and have nothing to do with revenue and therefore should not be considered in income-tax matters.

I am not interested particularly at this time in the items which are deductible or not deductible under the present income-tax law. Law speaks in an imperative manner. As Blackstone says "it commands or prohibits" and it must be obeyed after enactment. But law is supposed to be founded upon justice and equitable principles, and a frank and full discussion of principles by the people has everything to do with the laws which ultimately remain on our statute books.

I contend with Mr. Bauer that capital accretions should not be taxable and that only revenue accretions or income should be taxable under an *income-tax* law.

Yours truly,

ARTHUR BERRIDGE.

Portland, Oregon, March 18, 1921.

Book Reviews

FEDERAL INCOME-TAX PROCEDURE, 1921, by ROBERT H. MONTGOMERY. The Ronald Press Co., New York. 1205 pp.

When the reviewer ventured to suggest some years ago in the course of review of Montgomery's *Income-tax Procedure, 1916,* that the prospective flood of treasury decisions might warrant a two-volume edition of this work in the near future he little foresaw this day when the matter has expanded to a 1200-page manual on income-tax procedure—to say nothing of the second volume covering the excess-profits tax. And now Col. Montgomery grimly hints in his preface that proposed enactment of a general-sales tax without preliminary consultation by congress with public accountants (which is unlikely) will result in "a tremendous aggregate of professional work," a statement which makes one tremble at the prospective size of the next edition of *Income-tax Procedure.* There are those who hold that the income tax is the ideal method of raising public revenue because it is the fairest and simplest way to extract money from the taxpayer. Fairest it may be, but simplest? Could any method be devised (always excepting the marvelous excess-profits tax, of course) that would have more far-reaching ramifications and bring up more puzzling complications? Let Col. Montgomery's twelve hundred pages of law, decisions and comments answer.

Those who have been obliged to keep posted on the income-tax laws from the beginning will undoubtedly echo the author's statement (page 15) that "the 1918 law is simpler and more equitable than its predecessors," but it is doubtful if the thousands who were caught in the net of lowered exemptions will agree. In his own experience the reviewer has been amazed at the inability of otherwise shrewd business men to understand the purport of apparently plain questions on the returns. Some of this may be due to thick-headedness, to be sure; but it must be admitted that often the highly technical language of the return is partly to blame. For instance, the first instruction on the small form has misled many to believe that no return was necessary because the average small retailer or wage earner takes net income to mean what he has left of his total receipts after paying all his expenses, including personal, for the year. Even Col. Montgomery fails to make the point clear in his definition of net income (page 27) when he uses the broad term "less deductions for expenses" without the important qualification "incurred in business or trade." Surely it would be an easy matter to state on the return in parentheses "i. e., total income less business expenses." To be sure this is not a comprehensive description of what the law regards as deductible expense, but it would be close enough to put the unwary on notice.

As a matter of course the author follows the order and classification of items of income and expense used in the statute, which is not the order followed on the returns. Familiarity with the law and the form enables the experienced accountant to turn to the pages he may require, but we should like to see the manual follow the order of the return. It would be more serviceable to the neophyte or the ordinary business man. At all events, an additional contents-page indicating the pages covering each schedule of the return would prove a time saver.

It is a happy suggestion (page 87) that corporation returns should be prepared on forms 8½ x 11 inches in size and it might well be extended to partnership and individual forms. Typewriters are widely used these days and with the advent of the portable machines now being put on the market by several manufacturers their use promises to become well-nigh universal.

The instructions as to making returns under oath (page 89) prompts the reviewer to ask a question which has been on his mind for some time: Why should the government require returns to be attested at all? Beyond adding to the income of thousands of notaries public no particular good seems to arise from it. The income-tax bureau itself certainly disregards it whenever it calls upon a taxpayer to substantiate his return with additional information. It would seem as if signing with a competent witness would be sufficient to establish judicially the fact of signature. In the early days of withholding and monthly returns, when it really seemed as if every communication of any kind with the government had to be sworn, the writer had a voluminous and testy correspondence with a patient but helpless collector on this subject, in the course of which he showed that the withholding, payment and returning of a tax of $1.75 cost the corporation he served $5.20 in notarial fees. Things have improved since then, but there is still a bit of the old red-tape about the present regulation which requires a trading concern to have the inventory attested as well as the return. Considering that the signer of a return swears to the accuracy of everything in it, including the inventory in schedule A, this seems superfluous, to say the least.

A question interesting to public accountants is touched upon by the author in his remark (page 125) "it should be noted that the plenary power of examination" (by treasury officers) "extends also to persons other than the taxpayer who have knowledge of his income." What becomes of the professional secrecy of the public accountant in such case? The author is silent on this point. As far as the reviewer can ascertain, it seems to be the general opinion in the profession that the public accountant cannot plead privilege, as a lawyer can, if he is called upon to answer the questions of a treasury agent. This might give rise to a curious anomaly. A taxpayer is sometimes obliged to consult his lawyer as well as a public accountant in preparing his return. In case of later investigation the lawyer could plead privilege and refuse to answer, in which he would be upheld by the courts, whereas the accountant, who may have acted upon the advice of the lawyer, would be compelled to answer. It is obvious that if this is good law and practice there can be no confidential relationship between accountant and client in income-tax matters. This problem is serious enough to warrant the attention of the American Institute.

The inequity of requiring the recipient of tax-free bond interest to return the 2 per cent. paid by the corporation is discussed by the author with his usual clarity. As he points out, the corporation in effect pays the

8 per cent. normal tax for the stockholder but the latter is not obliged to include this tax as additional income. The reviewer would go further and say that the taxing of bond interest to the recipient while exempting the receiver of dividends is also inequitable. Following the judicial fashion of the day of looking through the form to the substance, it is common knowledge and common sense that interest on bonds is as much a part of profits as dividends. This is not orthodox, but it is true. Interest paid on current loans may be a legitimate business expense, but interest paid on bonds which are a part of the permanent capitalization of a corporation is not an expense but a guaranteed, limited share of the profits. It would be better and more equitable practice if the corporation income tax were levied on net earnings *before* interest. Then the bond holder would be placed in the same position as the stock holder and relieved from the normal tax on bond interest. There would then be no question of covenant tax-free interest to worry and obfuscate the recipient of the interest, for the tax on the net earnings of the corporation would not be a tax on the bond interest per se. This change would necessitate still another definition of net income as applied to corporations, but congress has become quite skilful in definitions of late years. The increased taxes from corporations would take the place of the excess profits tax in great measure. If reports from Washington are reliable there is to be an increase in corporation taxes anyhow, and this method would have the advantage of doing away with the present cumbersome and irritating method of collecting and returning tax-free interest.

Col. Montgomery handles the subject of reasonable salaries, bonuses and Christmas gifts in a vigorous and common-sense way that one wishes would clear the rather foggy atmosphere in the tax bureau. There is a slight error in stating that the case of the *U. S. v. Phila. Knitting Mills* was brought under the 1917 act. It was under the 1909 excise-tax law, but nevertheless, and notwithstanding the letter of Special Assistant United States Attorney Walnut contending that the decision of the United States district court did not apply to the income-tax laws, the principle laid down by the court is broad enough to cover them all. The gist of the decision is that while congress undoubtedly had the power to limit the amount of reasonable salaries or compensation as deductible expense it did not exercise such power; therefore no such power of deciding on the amount of reasonable compensation to be allowed was delegated to the commissioner. Subject to affirmation by the higher courts this practically nullifies this clause in the 1909 and all subsequent acts. At present the test of deductibility is, in the author's words, "whether or not they are legal and are in fact payments purely for services." The reviewer, however, cannot follow Col. Montgomery in his further doubt that "congress may delegate this power" (of limiting the amount of deductions for salaries) "to the commissioner." He goes on to say: "If this discretion may be delegated to him, why could not congress go a little further and say that corporations and individuals shall pay a tax on a net income which shall be determined by the commissioner of internal revenue?" What else has congress done in sec. 1317 where it is provided that the commissioner "may, from his own knowledge * * * make a return * * *"? It is a penalty clause to catch slackers, to be sure; but the power to fix the amount of net income is certainly delegated to the commissioner.

On page 655 the author refers the reader to the second volume of his manual for a form of reconcilement statement important to any taxpayer who keeps books. This will not trouble the public accountant who will naturally have both volumes, but is it not rather an imposition on the individual or partnership to be obliged to buy the second volume which deals with a subject confined to corporations? The form should have been given in this first volume as well.

W. H. LAWTON.

HORATIO NELSON DRURY

Horatio Nelson Drury, a member of the firm of Pace & Pace, New York, and a well-known educator, died of pneumonia March 7, 1921, at his home in Brooklyn, New York. Mr. Drury was born in Burlington, Vermont, educated in the schools of his native town and was graduated with honors from the University of Vermont in 1900. He was well known for his teaching of English in several of the large business organizations of the country and also as a lecturer and author of text-books.

Haskins & Sells announce the consolidation of their practice in and about Kansas City, Mo., with that of F. M. Weaver. F. M. Weaver will be associated with Page Lawrence in the management of the office.

Riggins & Beck announce the opening of offices in the First National Bank building, Bartlesville, Oklahoma, and South Western National Bank building, Oklahoma City, Oklahoma.

Ernst & Ernst announce the removal of their office to the fourteenth floor of the Hanna building, Cleveland, Ohio.

William Gray announces the opening of an office at 1107 McArthur building, Winnipeg, Manitoba.

A. Meltzer & Co. announce the removal of their office to 147 Fourth avenue, New York.

Bennett & Berck announce the removal of their offices to 116 West 39th street, New York.

George Illmensee announces the removal of his office to 82 Beaver street, New York.

Edward C. Smith announces the removal of his office to 15 Park Row, New York.

G. Ed. Ross announces the opening of an office at Salem, Oregon.

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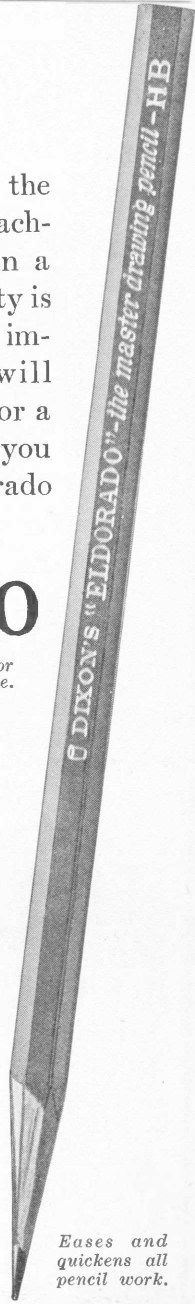

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