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The attitude towards the appraiser and an appraisal for income-tax returns has been, to a considerable extent, a matter of controversy—I might say, of misunderstanding; therefore I am glad to have the opportunity to come in contact with you, as it has brought to me a realization of some things you are thinking and that I have an opportunity to talk against a negative feeling, upon your part, towards my subject.

It has been my privilege to go about the country somewhat in the last few years asking a question of my accounting friends, my legal friends and the officers in the internal revenue bureau as to what "an appraiser has to do with invested capital." My friends usually replied in this vein: "Why don't you know that an appraisal has nothing to do with invested capital?" Perhaps some of you here have the same thought in mind. My reply has been, "That depends upon our definition of the 'appraisal.'" I further stated that I believed the existence of the property itself was fundamental evidence as to the capital invested; and that when you had measured that property in terms of actual costs and allowed for depreciation in accordance with its expectancy of life, you had the basic proof as to the capital invested in the plant properties. There seems to be no objection, no real objection, to this premise: in reality it is the existence and the remaining serviceable life of the property that is the proof of the capital invested at the beginning of and during the taxable year.

As accountants, you may have sometimes discovered that there are, for a number of reasons, missing links in the record covering plant properties; and in our investigation it is our purpose to discover what property there may be in existence that may not appear in the plant asset account or that may appear in the account where there is now no property in existence.

When we have furnished the information which will permit the correction of the plant account so that it will correctly reflect the property in existence and its remaining expectancy of life, we have furnished that part of the information which goes into the correct determination of the invested capital.

Where those links are missing in the recorded costs it is necessary to supply the next best information. In order to do

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this we make an historical investigation of the properties, ascertaining the dates of the original construction and equipment, and the dates of subsequent additions or deductions, using the recorded data as far as obtainable, until we have an inventory of the properties scheduled in accordance with the dates of acquisition. From the records through the accountant or otherwise we endeavor to ascertain the original costs of the property to apply to that inventory. Where we find no existing records of actual cost we substitute for that missing record a normal price known to have prevailed when the property was acquired, constructed or equipped, to permit a correction of the record. This method has been discussed and demonstrated in practice and has not been challenged; in fact, I think it has been quite generally recognized that this is the basis for the reconstruction of invested capital.

There are three primary purposes for which we use appraisal service with income-tax returns. I might explain here that you and I differ as to the definition of the word "appraisal"; and you may not call the process which I have just described "an appraisal." It is, however, relatively immaterial whether you call it an appraisal or by some other term. The common conception of an appraisal, as a result of the historical development of appraisal work, has come to be synonymous with the "determination of current values." That is the basis for most of our misunderstandings in reference to its application with income-tax returns.

As I stated, there are three fundamental purposes for which we use appraisal advice with income-tax returns: for assistance in the reconstruction or proof—if it does not need to be reconstructed—of the invested capital; for determining March 1, 1913, values of the property acquired prior to that date; and for determining the amount of amortization that may be written from investment on war construction and equipment.

Plant accounts entering into invested capital of course may be incomplete. The reasons you know. In the earlier days betterments may have been charged to expense in such a way that they cannot again be conveniently segregated; excessive charges or no charges may have been made for depreciation; or the records may be lost in whole or in part. It is the testing of the plant accounts against the properties that brings out the evidence that is required for their reconstruction properly to show the capital invested and the depreciation sustained to date.

This process should have the closest coöperation between the accountant and the appraiser in order that the accountant may give to the appraiser the information which is available from the accounts and that the appraiser may check these against the properties and determine wherein they are excessive or deficient. Through an appraisal we not only increase invested capital but we may also furnish the evidence whereby the invested capital may be decreased. It is common to find the account of property still upon the record, when the property has been abandoned or superseded, and the superseding property also capitalized.

There will not be time for me to enter into the technique of the appraisal work involved nor the detail of the investigation into historical development or properties nor the reconciliation of the properties with plant accounts. But of course you understand that in order to make the evidence complete it is necessary that the result of the appraisal be harmonious with the accounts, in order that the adjustments may be made specifically during different years and for the different types of property for which we desire to reconstruct the plant accounts.

We now have the inventory, with the actual prices as far as they are available or, when those are not available, the normal prices prevailing at the date. We come to that period of March 1, 1913, to determine the values at that date, and it merely involves a re-pricing of that portion of the property acquired prior to March 1, 1913, according to known prices prevailing on that date, and getting the depreciations that have occurred up to March 1, 1913, in order to determine the market value or the then value of the property.

Here another operation comes in: recording the property that may have been abandoned subsequent to March 1, 1913, in order that such property be accurately recorded as of March 1, 1913, with its depreciation, and that the subsequent depreciation and any further deduction which may be required at the date the property was abandoned may be provided.

The third purpose—that of amortization—involves the segregation of property added for war purposes subsequent to April 6, 1917. This we should receive from the accountant with the actual cost, segregated in such a manner that it may be checked against the property acquired. The amount of amortization is determined for two classes of property: that which has been or is to be abandoned and that which will remain in the service of the company. For that which has been abandoned, it is of course a matter for the accountant to determine the difference between the investment and the selling price (if it has been sold) or possibly for the appraiser, if the salvage value is to be determined. However, the second division, which concerns itself with the useful value of property retained to the industry, involves a consideration of a number of facts in reference to the normal post-war conditions of that particular business.

There are certain factors entering into that which undoubtedly come within the scope of the auditor, such as the measuring of the post-war activity in comparison with the war activity in terms of productive hours, fuel consumption, tonnage produced and other similar factors. But to my mind these are not sufficient to answer the question nor to determine the amount of amortization. The factor of usefulness of that property to the taxpayer, based upon its normal post-war production, involves questions of engineering and appraisal practice to determine in detail the utility of the units of property for post-war purposes.

I have in mind a foundry which was constructed for war purposes to produce a heavier product than that involved in the normal production of the taxpayer. This foundry was constructed of heavier design and equipment, larger than would have been required for the normal requirement of the taxpayer. The building cost was naturally greater on account of the heavier steel construction needed to carry a twenty-five-ton crane where a fifteen-ton crane would have met the normal requirements. The equipment was correspondingly increased and had a heavier capacity. Such a condition involved the determination of what a normal post-war cost would be of a foundry building to meet the post-war requirements of the taxpayer and the extra cost in cranes and other equipment on account of the heavier type of product turned out for war purposes. It necessitated the amortization of the actual cost to what would have been a reasonable investment under post-war conditions to have acquired equipment applicable to the post-war requirements of that particular taxpayer.

I will give you another instance of a power plant which had to be built much larger than the normal requirements of the taxpayer, where, if the power had been available, as it would have been under post-war conditions and requirements, the building of a power plant would not have been required at all, as central-station electric power could be purchased cheaper than the tax-payer could generate it in a plant of his own.

In ascertaining the value of the power plant to him under post-war conditions consideration should also be given to the extra cost of generating the power, considering fixed charges against the investment and properties and the operating cost, in comparison with the price for which he could have purchased that power.

The foregoing outlines the general plan of the work which we would do as an appraisal organization to meet these three fundamental requirements for appraisals with income-tax returns.

There is one point which has been a subject of much misunderstanding, some uncertainty and controversy: the so-called working backwards to determine a valuation at a prior period and doing so at a later date or at the present time. Such valuations are required where the conditions permit the surplus to be adjusted in accordance with the value of the property at date of acquisition—conditions with which you are familiar—as well as the values of March 1, 1913.

It is questionable if values worked backward for present values stand for that purpose. I do state though that the correct process of developing those values is not to work backward, but forward, as I shall attempt to demonstrate to you. I here digress sufficiently to discuss the difference between "personal-opinion values" and organized appraisal values. In the evolution of valuation work we have developed from the personal-opinion values, which may be perfectly competent, as based upon individual experience and judgment; just as valuations determined in accordance with the personal opinion of the individual may be perfectly competent and accurate values. But in determining organized appraisal values, we build up from definite bases of data, statistical, historical or current, in accordance with standardized and tested methods, with checks and balances to coördinate the work of the individual with the work of the organization; and we obtain what we characterize as provable values, because, regardless of what the valuation is and whether it is expressed in a total sum of a million dollars or in itemized detail, it can be traced back through the systematic standard practice methods and records used in its computation; checked against the standard cost analysis, prices and values that have become a part of the organization records; reduced through the different processes to the basic elements entering into the property, all of which have been tested against practical business transactions during the history of the appraisal company.

If we understand this point, the difference between personal-opinion values and organized appraised valuations, we shall begin to consider the problem of valuation as of any date as a matter of logical development and not the result of working backward. For instance, with our historical records it is as easy to determine the cost in 1900 or March 1, 1913, or any other prior date, as it is to determine the cost today; possibly it is easier, because costs today are somewhat harder to find. But there is no question as to what prices were on March 1, 1913; it is a matter of record demonstrated and tested at the time and proven since. So, if it becomes a question of determining the value of a property at the date of its acquisition or March 1, 1913, it is simply part of the historical investigation to determine the existence of that property on that date. That may be difficult or it may be simple, depending on the character of the changes that have been made and the kind of records that have been maintained. But difficulties have to be met when they are encountered. The result is that the fact has to be determined in accordance with this available information.

Having determined that, it is a question of the application of the unit prices prevailing on that date and the depreciation that would have been right in accordance with the conditions of the period. That isn't working backward. It is the use of data, known at the time, applied to conditions which existed at the time.

I have not found any objection to that method. In the department there have been appraisals thrown out and properly so. I don't hesitate to say there have been accountants' reports thrown out. It may have been error to throw out the accountants' reports; but I will admit that there have been appraisals thrown out for good cause—they should have been thrown out. As appraisers, we like to see the standards maintained, and to my mind the department can not be too strict in acceptance or rejection of appraisals.

I should like to discuss depreciation and the difficulties now encountered in the treatment of it for income-tax purposes, but that is too long a subject. I want to refer briefly to a few other items.

Let us touch briefly on the question of patterns and drawings, a vital matter in our discussion, because here is an account which has most likely been written off and some technical difficulties may be met in its reconstruction. On the other hand, the department has issued reasonably clear instructions in reference to this subject. The reconstruction of the pattern account probably required a more painstaking investigation than the building and equipment accounts. You have the questions of depreciation, obsolescence, inactivity, one pattern succeeding another pattern, models may have been changed, cost records are incomplete as to the cost of each individual pattern or the individual group of patterns. It is, therefore, desirable to make an analysis of the entire pattern-department expense or the drawing-room expense, by years, and to judge what portion of that might be reasonably expected to be capitalized. Then tie that with the cost of the patterns made during the respective years, priced in accordance with the normal prices for each year, as proven by an appraisal of the actual active patterns, balancing them together in order to complete your proof.

The question of patents comes up for consideration on account of the privilege the taxpayer has of writing off his patent values of March 1, 1913, as an expense to the remaining life of the patents.

Goodwill is a live problem. Many firms have their goodwill reconstructed in accordance with March 1, 1913, values. Sometimes it may be purely an accounting proposition; at other times it involves an appraisal problem relating to the character of the business, its mechanical operations, its markets, its future and investigations which may supplement the service which the accountant would render.

In closing I wish to lay the foundation for your consideration of what I believe to be the constructive work that appraisers are doing today in the making of appraisals on an historical basis, whether or not this is taken into consideration in the reconstruction of invested capital for income-tax purposes, because the same principles enter into the correct determination of plant accounts for ordinary business, accounting and financial control. We want to know what the plant properties, on the basis of investment, should represent in dollars and cents on the books of account. If the book account as carried forward historically does not represent that, it is sound and conservative business to have it reconstructed so that it shall do so, because it is better to be right than conservative. It is a question if we shall ever go back to the practice of having our plant accounts stand upon the books at the most conservative value; we may take the position that they should represent the facts, even though there is no compelling power like excess-profits tax to make that a matter of desirability or expediency for saving in tax payments.

As we shall probably have March 1, 1913, values as a basis for depreciation and for the determination of the profit or loss on the subsequent sale of capital assets, it seems to me highly desirable for forward-looking businesses now to have their March 1, 1913, values determined, not only for their protection during current and past years, but as a protection against the future, when there may be a transfer of the business whereby taxable profit will be a matter of concern. So I say that it is important to see that plant accounts, pattern and drawing accounts and goodwill accounts are now authoritatively and definitely determined, for protection against any future transfer of the business or of the stock.