Recognition of Auditor's Importance

An impressive evidence of the recent trend toward distinct definition of the duties and rights of an auditor is found in the certificate of incorporation of the Southern Natural Gas Company. We quote the following from section 8, paragraph (k):

“At each annual meeting of the stockholders, or at an adjournment thereof, there shall be elected by plurality vote of the outstanding shares of the class A stock an auditor of the corporation, who shall hold office until the next annual meeting of stockholders. The board of directors may appoint an auditor to hold office until the first annual meeting of the stockholders. The auditor shall be an individual who is a member in good standing of the American Institute of Accountants or (if said Institute shall cease to exist) of its successor or an organization of comparable standing, or shall be a co-partnership a majority of whose members are members in good standing of said Institute or its successor or comparable organization as aforesaid; and shall in any event have rendered audit reports for at least five corporations or associations each having at the time of such reports assets carried on their respective balance-sheets at more than $20,000,000. The auditor shall not be a director of the corporation, nor (except an auditor then in office) an officer or salaried employee thereof. Not later than thirty days prior to the day fixed for the annual meeting of stockholders in any year, the auditor shall submit a written report by the auditor as to the balance-sheet of the corporation as at the close of business on the December 31 next preceding the date of such report, as to the surplus account of the corporation and as to the earnings or income of the corporation since its organization or since the last preceding report by the auditor as the case may be. The corporation shall cause copies of such report to be mailed not
later than twenty days prior to the day fixed for such annual meeting to each stockholder of record of the corporation. The board of directors of the corporation shall cause to be included in the notice given to stockholders of each annual meeting a statement of the name of the individual or co-partnership which the board of directors recommends for election as auditor at such meeting, and also a statement of the name of the auditor then in office; but no such recommendation by the board of directors shall be binding upon the stockholders. The board of directors shall cause a copy of such notice to be mailed to the existing auditor at the same time at which it is mailed or otherwise given to stockholders. No person, other than the auditor then in office, shall be eligible for election as auditor at any annual meeting of stockholders unless notice of intention to nominate that person as auditor has been given by a stockholder to the corporation not less than ten days before such annual meeting; the corporation shall promptly mail a copy of such notice to the auditor then in office. The auditor shall have the right to attend all meetings of stockholders at which the auditor or any accounts of the corporation examined or reported on by the auditor are considered, and to make any statement or explanation regarding the accounts which the auditor may desire; but the auditor shall not be entitled to any vote. The auditor shall have the right of access to all books, accounts, vouchers and records of the corporation and may require from its officers such information and explanation as may be necessary for the performance of the duties of the auditor. The officers and directors of the corporation may rely upon the accuracy of all reports by the auditor to the corporation or its stockholders and will be protected in any action or non-action by them in good faith in reliance thereon. Semi-annual, quarterly or interim reports shall be made by the auditor from time to time as may be directed by the board of directors of the corporation. The board of directors may fill any vacancy occurring in the office of auditor, by death, resignation or otherwise, at any time except between the call and final adjournment of an annual meeting of stockholders or of a special meeting of stockholders called for the purpose of removing the auditor or electing a new auditor. The auditor may be removed, and a new auditor elected to fill the vacancy caused by such removal or otherwise, at any special meeting of the stockholders the notice of which shall include such removal and election as purposes of the meeting, by the vote of a majority of the outstanding shares of the class A stock of the corporation; a copy of the notice of any such meeting shall be mailed by the corporation to the auditor then in office at the same time at which such notice is mailed or otherwise given to stockholders. The auditor shall receive as compensation for all services performed by the auditor such amount as from time to time shall be fixed by the board of directors within such limits, if any, as may from time to time be determined by the stockholders."
This matter which we have quoted from the certificate of incorporation of the Southern Natural Gas Company seems to us to be the most comprehensive and satisfactory series of provisions which has been written into any American charter or certificate of incorporation. The auditor is entirely removed from any possible sense of dependence upon the whim or animus of the directors or officers and is placed in direct relationship with the owners of the corporation. This follows the principle underlying the English companies acts, but the clarity of the language and the lack of any ambiguity in the placing of responsibility seem to excel anything found under the English acts. Everyone knows, or is supposed to know, that the corporation is the property of its stockholders and that the directors and their appointees are simply the servants of the owners of stock, but it is equally common knowledge that in the United States the indifference of stockholders has created something resembling an absolute dictatorship by the directors. As a consequence most auditors have been appointed by the officers or directors without even so much as a formal approval by the stockholders. This has led to a condition not altogether desirable and it has interfered seriously with the exercise of the auditor's true functions. The clause in the certificate now before us relative to the supersession of one auditor by another without due notice is excellent. There is no reason whatever why the audit of any corporation should be passed around from office to office in what looks like a sort of benevolent impartiality but has sometimes been merely a slightly disguised expression of distaste for the nature of the report which the former auditor felt it his duty to render. In most cases, unless there be some special reason to the contrary, the welfare of the corporation is best served by continuity of audit. Even with all the working papers and audit reports of preceding auditors before him a new auditor must find himself at some disadvantage in taking up an investigation of any corporation of considerable size. What has been called the rotation of auditors is as unjustified in most cases as would be a rotation of physicians or of lawyers. The professional man who has been in touch with all the detail of the recent past is better equipped than any one else can be to carry on the work and intelligently to advise the directors and officers of the corporation.
Reliance Upon Auditors' Reports

Another very important feature of the certificate which we are considering is that it states that the officers and directors of the corporation may rely upon the accuracy of all reports by the auditor to the corporation or its stockholders and will be protected in any action or non-action by them in good faith in reliance thereon. This answers in part the objections of many directors to the liability provisions of the securities and securities exchange acts. They are not charged with personal inquiry into the accounting details of the business but are entitled to rely upon the auditors' reports. It places a definite responsibility upon the accountant which he should be willing to assume. He must bring before the directors any important developments in the business relating to accounting matters that come to his attention. Since the officers are also entitled to place reliance upon the auditor's report, there will be a mutual responsibility: the auditor is entitled to rely on the officers' certificates with respect to contracts and contingent liabilities, subject, of course, to the usual tests and inquiries that he makes in his examination. This phase of the accountant's responsibility is not new, but it is a striking example of the increasing importance in this country of the independent public accountant in corporate affairs.

An Important Document Revised

On January 6th, the American Institute of Accountants distributed to its members a pamphlet entitled Examination of Financial Statements by Independent Public Accountants. This was a revision of earlier works prepared by the Institute. The history of the case is well known to most readers, but it may be worth while to recite briefly. In 1917, Edwin N. Hurley of the federal trade commission, a bureau then newly created, suggested to members of the American Institute of Accountants that it would be helpful to the government to have some sort of outline of what accountants themselves considered should constitute the minimum program of audit in the case of corporations of medium size. A committee of the Institute prepared such a program, based largely upon an office manual in use by one of the larger firms, and submitted it for consideration of the federal trade commission. Mr. Hurley in turn referred the matter to the federal reserve board, which was also a comparatively new arm of the government. The reserve board gave long consideration to the
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recommendations of the Institute and officially sponsored publication of the document under the unfortunate name _Uniform Accounting_. Nothing resembling uniform accounting was intended and in subsequent editions the name was changed to _Approved Methods for the Preparation of Balance-sheet Statements_. This matter was published in the _Federal Reserve Bulletin_ and reprinted in pamphlet form by the government. In 1927 and 1928 the matter was again revised by the Institute and issued under the sponsorship of the federal reserve board under the title _Verification of Financial Statements_. There have been many important developments in accounting practice during the last few years and a marked increase in the emphasis on accounting principles and consistency in their application. It was felt that there was need for a further amplification and revision. In 1935 the Institute therefore appointed a new committee to revise the plan of procedure, and the work was completed in December last. This time the Institute itself published the recommended program. The committee which has had the work in hand deserves high commendation for the thoroughness of its labors and the excellence of its results. The new program of audit has been expanded somewhat beyond the original outline and more attention is devoted to the income statement and profit-and-loss account. There is reference also to the audit of larger concerns in which there is an adequate internal check which dispenses with the necessity for some of the detail work required in the audit of smaller concerns. In the advertising pages of this issue of _The Journal of Accountancy_ there is announcement of the publication with particulars of price and method of obtaining copies. We believe that every accountant should have this revised program in his possession and should consult it frequently. It will certainly have an important place in the procedure of the future.

"Only a Billion" When the congress of the United States assembled on January 2nd it was understood that one of the first subjects of consideration would be the passage of an act authorizing the payment of some sort of a bonus to men who had seen service in the military forces of the United States during the world war. This annoying question has engaged as much attention as any other one piece of contemplated legislation in the recent history of the country. There are marked differences of opinion as to the justification for any bonus what-
ever, the amount of bonus, if one be considered at all, the nature of payment and the source of the money required to make payment. All this is common knowledge, and as this magazine goes to press it is not possible to foretell with any degree of assurance the exact nature of the fate which will befall this latest effort to bestow recognition of a financial sort upon the soldiers and sailors and marines who were called to the colors. There is, however, one extraordinary feature of the case which seems to be ominous. It was said shortly after the assembling of congress that the plan most apt to be adopted would cost immediately only one billion dollars. Now, if each one of us will pause to think a moment about that word "only," he will find himself somewhat amazed. It is clearly within the memory of many of us not utterly senile that when we went to school we were told that the debt of the United States, partly as a heritage from the civil war, stood at the enormous total of about one billion dollars. The word "billion" had connotations of infinity. It was a sum of money quite beyond the mental grasp of any one. It was something terrible in its enormity, and our teachers told us, in those timorous days, that some time perhaps the nation would be so wisely guided and governed that this awful debt could be wiped out and we should again be able to look the world in the face as a solvent nation. We are not at the moment concerned with the economic soundness of the pedagogic mind of those days. The point which is impressive today is that we, a nation badly seduced by political leaders, have reached a stage at which we speak of "only" a billion. Of course, the country has developed tremendously, and money has been plentiful and scarce and plentiful again, as we have passed over the hills and valleys of our national progress, but if each one of us will indulge in a little mental experiment he will find that he has become somewhat dulled to the awfulness of billions. Even twenty-five years ago if any one had spoken of "only" a billion he would have been regarded as totally ignorant or ponderously playful. The sad truth is that we have lost our sense of values and the perspective of values. Probably fifty per cent. at least of the people in the United States consciously or unconsciously breathed a sigh of relief that the latest bonus plan involved only a billion at once and a few more billions later. We need new glasses at which to look. Too long have we had those mirrors of distortion which make great look small and very small sometimes look very great. We want the kind of mirror which will reflect truly
so that we can see ourselves and what is before us and also—perhaps more important than we think—what is behind us. Only a billion, indeed.

An Attack on the Fortunate Few

An accountant, who confesses that he has not yet achieved either fame or fortune in the field of his chosen profession, expresses with some bitterness his belief that the rules against professional advertising are inspired by the desire of those who have arrived at eminence to prevent the success of those who still are seeking to climb. He says, with an altogether admirable bluntness, that it is all very well for the men who have reached the top to assume an air of unctuous rectitude, but it is not so well for those whose struggle to arrive lies before them. According to this protestant there is no need for the man whose practice is as large as he wishes it to be to indulge in self-advertisement, but the man whose practice is sadly below the point of satisfaction must do something to make his name known and to attract clients. The complaint goes on to cite what is described as the hypocrisy of the leaders of the profession. They, it is alleged, occupy positions of prominence in the community; they write books which are widely read and widely advertised; they perform services to the government which bring their names frequently into print; they are, in a word, outstanding and therefore conspicuous. According to the complaint the men who do these things obtain the most fruitful kind of advertisement, whereas the little fellow may perform a thousand important tasks in the most excellent way without obtaining that pleasing contentment which follows the publication of one's accomplishments.

Great Success Always Is Conspicuous

We believe that there is a great deal of this sort of sentiment among men whose success is still before them. No doubt they over-estimate the delight of seeing one's name in print. It is probably true that most men whose names and deeds are brought to public attention grow so quickly accustomed to the experience that it becomes of little value—a matter of almost complete indifference. Leaving that aspect of the case aside, however, there is a very great deal of truth in the old adage that nothing succeeds like success. Many men who have spent the greater part of their lives in doing the best they can are so ignored
by fame and reputation that few people outside the inner circle of their acquaintance know anything at all about them. They labor in a narrow field and what they do helps in a modest way to bring in the better day, but there is never a fanfare of trumpets to herald their progress. They are vitally important cogs in the machinery, which because of their running smoothly make little noise. Without them the machinery would stop. All this is well enough known and in the contemplation of equity and justice is deplorable. Every one should receive public credit for good work consistently done. But some kinds of work do not call forth public acclaim. The man who can write and speak so that others want to read or hear him; the man who can present thoughts so well that others will probably remember him undoubtedly has a distinct advantage, whether it be from natural aptitude, education or experience. But this condition is not peculiar to accountancy. In every group of a thousand lawyers there may be ten whose names are known throughout the land; and they may not be as sound in the law or as ethical in its practice as the 990 whose field of action is in small communities or in minor matters in great communities. Some must achieve success and many must miss the reward of high honors. If we narrow the discussion to the profession in which readers of this magazine are chiefly concerned we find that the experience of accountants is exactly parallel to the experience of lawyers, medical men, architects, engineers and the like. If we understand correctly the nature of the complaint which we are considering it is a protest against the free advertising which comes to men who are well known, and it appears that the sentiment underlying the complaint is partly jealousy but chiefly a feeling of regret that fame can not be more evenly distributed. One might almost believe that the complaint in the present case would prevent the leaders of the profession from acting as leaders and would prefer to see them relegated to the inconspicuous ranks where most accountants march. Yet such sentiment is really unworthy and if carried to extremes may become merely ridiculous. Would any one say that because a man is prominent in his profession he should refuse to permit any mention of his name in print, he should refuse to sign his name to his writings, however important they may be, he should retire into some obscure recess of the mountains and let no one find the path to his door? Instead of acting as a leader should he insist upon following the lead of some unknown colleague?
Method and Motive Must Determine Propriety. But the complainant says that this writing of books and doing of important work is really a form of advertising. There is no possibility of effective contradiction. Every noteworthy accomplishment is an advertisement, whether one will have it so or not. The rules which prohibit advertising can not prevent, and we believe were never intended to prevent, the accumulation of honor and high standing. Advertising in the sense which the general public understands—the same sense in which the rules of accounting organizations were written—relates to that form of publicity which is instigated and carried on by the person advertised. For example, if an accountant buys space in a newspaper (whether in the advertising columns proper or in that scarcely more subtle device known as a special edition or a "write up") and devotes that space to an exposition of his name, talents, organization and supposed excellence he is doing something which is contrary to the spirit of every profession. The rules forbid it. If another accountant has so established his reputation for experience or wisdom that he is called in by the government to give advice or to carry forward some great undertaking, the newspapers will be filled with his name without any encouragement or suggestion by him. That, we maintain, is not advertising in the sense implicit in the rules of conduct. Indeed it may be said that the distinction between unethical advertising and ethical prominence is drawn by the source and motive of the publicity. The accountant who himself causes the publication of his name for purposes of notoriety is unethical. The accountant to whom honors and great repute accrue without his own volition can not be condemned or even adversely criticized. It will be said, of course, that this argument expresses the sentiments of those who have attained success and ignores the quite reasonable dissatisfaction of those who still labor among the multitudes in the street below. We say that such things will be said but we do not admit that they can be fairly said. There may be no justice whatever in the incidence of fame. Fame may attach itself where it is least deserved and may pass entirely by the point where it is properly attributable. As a general rule, however, there is good reason for every success. It may be merely an uncontrolled combination of circumstances which pushes one man up above the throng—but this is rare. He who succeeds generally will be found to have inherent ability, a tireless energy and above all a confident assur-
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ance of his own power to achieve. The whole question of what may be called voluntary and involuntary acquisition of success will be with us as long as any question in any realm of human affairs remains unanswered. We do not know why all men should not have been created equal, as the declaration of independence piously affirms them to be, or why equal opportunity should not knock at every door, but calm, impartial and intelligent students of this scheme of things entire agree that equality is of such small dimensions that it can not be stretched to include even a dozen of us. In the meantime all that any profession or trade or other vocation can do is to make the race as fair as possible, to see that every one runs according to the rules of fair play, and to avoid unjust and disquieting complaints. If some one should suggest that the next president of the United States should be chosen from the ranks of accountancy—a suggestion pregnant with bright cheer and infinite possibilities—the man selected would be the most widely advertised citizen of the country. Carrying our complaint to the ultimate such a man would be guilty of advertising.

An Eminent Accountant Retires

Accountants engaged in public practice and their fellows engaged in the service of corporations will learn with interest, tinged with regret, of the retirement of W. J. Filbert from the chairmanship of the finance committee of the United States Steel Corporation. Mr. Filbert retired on January 1st after twenty-five years of service in the company. His career is an outstanding illustration of a rise to high executive position through the accounting department of a corporation. He left the Chicago and Northwestern Railway Company to join the Federal Steel Company in February, 1898, and on the formation of the United States Steel Corporation in 1901 he was appointed assistant comptroller. He became comptroller in 1902. To Mr. Filbert is largely due the credit for the forms of annual report issued by the United States Steel Corporation, which have been regarded as models in that they gave adequate information to investors without disclosing information useful only to competitors. His place in the field of corporate accounting is as secure as his place in the history of the steel industry. Mr. Filbert has an extremely modest and retiring disposition, and the extent of his services is not fully realized outside the steel industry. He took an active
part in framing workable regulations under the first corporation excise-tax law in 1909, and he carried a large part of the load in the organization of the steel industry under N. R. A. All who have known him have recognized his fidelity to sound principles, his readiness to face facts squarely and to reflect them in accounts frankly and fairly. He has always been unalterably opposed to the policy of allowing erroneous items to stand on the ground that they are offset by equivalent items on the other side.
The Influence of Accounting on the Development of an Economy

By George O. May

II. Capital Value and Annual Income

One of the most striking contrasts between American and English financial and accounting practice is to be found in the fact that here we regard gains or losses on the sale of capital assets as finding a place in the income account, while in England they are regarded as increasing or decreasing capital. In this article I propose to consider some of the economic policies which may be in part at least attributable to the habit of mind which our practice reflects.

Unquestionably, the difference in practice does reflect a difference in habit of mind. Anyone who has lived both here and in England will recognize the truth of the statement that here we think in terms of capital value and there they think in terms of annual income. Inquire whether a man is well-to-do here and you will be told he is probably worth so many dollars; ask a similar question in England and the answer (if you get one at all) will certainly be that he is probably worth so much a year. It is not difficult to understand why this should be so. In England, modern business developed in a community in which previously the predominant interest had been in land and which already thought in terms of annual produce. The opening sentence of Adam Smith’s The Wealth of Nations (1776) reads:

“The annual labor of every nation is the fund which originally supplies it with all the necessaries and conveniences of life which it annually consumes, and which consists always either in the immediate produce of that labor, or in what is purchased with that produce from other nations.”

Cannan, in his edition of the work, comments on this passage as follows:

“This word (i.e., ‘annual’), with ‘annually’ just below, at once marks the transition from the old British economists’ ordinary practice of regarding the wealth of a nation as an accumulated fund” (Note 1, p. 1).

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He says, further, that:

"The conception of the wealth of nations as an annual produce, annually distributed . . . has been of immense value" (Introduction, p. xxxiii).

With us, business developed in a new country: the great opportunities for gain lay in sharing in the growth of the country rather than in securing a part of its current annual yield.

Three fields in which the effects of the difference in the point of view may be discovered at once suggest themselves—those of local taxation, rate regulation, and income taxation.

In colonial days, according to Seligman, there were many cases in which, while the tax was imposed on property, the assessment was made on the basis of annual value. This was true of Massachusetts, Rhode Island, New Hampshire, New York, Delaware and Virginia.* Bullock, in discussing the local general property tax, also mentions that Massachusetts as a province levied taxes on the basis of the annual value of property, but that the second tax law passed after the adoption of the Constitution of 1780 changed to the basis of capital value, which is today, in general, the basis of local taxation throughout the States.† Whether the causes of the change were in any way related to those which produced the more momentous political developments of that time, I am not sufficiently versed in history to say.

When we turn to rate regulation, it is apparent that the principles we have adopted were based upon the Federal Constitution as interpreted by the Supreme Court in a series of cases of which the most important was perhaps Smyth v. Ames (1898). So, too, the enactment of what was really an income tax law in 1909, and of an avowed income tax law in 1913, brought definitions of income in conformity with the same habit of mind in the cases of Stratton's Independence v. Howbert, Doyle v. Mitchell Bros. Co., and Eisner v. Macomber.

In Smyth v. Ames the Supreme Court decided for the first time that the basis for all calculations as to the reasonableness of rates must be the "fair value" of the property being used for the convenience of the public. Giving only the most general indication of how this value was to be determined by reciting some of the factors that must be considered without any expression of opinion as to the weight to be assigned to each, and making the clear

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† C. J. Bullock, Selected Readings in Public Finance, 3rd ed., p. 311.
reservation that there might be still other factors to be considered, the Court started that pursuit of the will-o-the-wisp of fair value which is still being carried on with no greater success than was to be anticipated. The charge made by Jevons against Ricardo, that he "shunted the car of economic science on to a wrong line," might perhaps with more justice be made against those who were responsible for bringing about the decision in \textit{Smyth v. Ames}.

In \textit{Doyle v. Mitchell} the Court held, first, that the value, at the date of the passage of the taxing act, of capital assets converted into manufactured articles and sold, must be deducted from the proceeds of sale before anything to be taxed as income could be arrived at; and, secondly, that the proceeds of sale or conversion in excess of that basic value were income.

On the first point, there is at least some appearance of inconsistency between this decision and that in \textit{Stratton's Independence}, in which the Court held that the proceeds of mining could be taxed as income without any allowance for the exhaustion of the mine which was a necessary incident of the operation. However, no distinction between the two cases was made in the decision in \textit{Eisner v. Macomber} which provided what has become the accepted legal definition of income in our Courts:

"After examining dictionaries in common use (Bouvier's Law; Standard; Webster's International and the Century), we find little to add to the succinct definition adopted in two cases arising under the corporation tax act of 1909 (\textit{Stratton's Independence} v. \textit{Howbert}, 231 U. S. 399, 415; \textit{Doyle v. Mitchell Bros. Co.}, 247 U. S. 179, 185): 'Income may be defined as the gain derived from capital, from labor, or from both combined', provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle case" (252 U. S. 207).

It may be noted that in presenting the Income Tax Bill of 1913 Congressman (now Secretary) Hull expressed the view that an occasional purchase not for immediate resale, followed after a substantial interval by sale at a higher price, would not produce taxable income thereunder. It would have been well, perhaps, if his view had prevailed.

The decision in \textit{Smyth v. Ames} forced the question of present value of capital assets upon the attention of all public utility companies. The income tax decisions made the value of capital assets at March 1, 1913 a question of cardinal importance for all
corporations owning capital assets at that date. The attention thus focused on the subject of present fair value, and the marked change in price levels which took place during the war period, together constitute an adequate explanation of the extent to which the practice of readjusting book values of capital assets to so-called present values was carried in the 1920's, which was criticized in the previous article of this series.

That the principles and practices, established as I have outlined, have met with scant approval in economic circles is indicated by examination of the works of economists of high standing. Upon the question of local taxation, Bullock says:

"After forty years' discussion, the United States has the most crude, inequitable, and unsatisfactory system of local taxation—if, indeed, we can call 'system' that which more resembles chaos—than can be found in any important country in the civilized world." *

And T. S. Adams speaks of the system as "A hypocritical pretense, a source of wholesale lawbreaking and chronic inequality, a by-word for inefficiency and injustice." †

Undeterred by this experience, we enacted Federal capital stock tax laws which required taxpayers to report annually under oath the "fair value" of property for which no market existed or was desired, and any real valuation of which would have involved the difficulties and complexities mentioned in my previous article and would have been useless for any other purpose than compliance with the law. Needless to say, in practice no real attempt to fix fair value was made—instead, the tax being relatively small, the taxing authority was usually able to collect substantially more than was justly due because the additional tax was less than would have been the cost of demonstrating its injustice.

This tax was abolished in 1926, but in 1933 it was revived in the particularly obnoxious form of the linked capital tax and excess profits tax—the corporate taxpayer was first permitted (and required) to fix the taxable fair value itself, with the knowledge that placing the taxable value low would increase its liability to excess profits tax on its income. The two taxes were imposed at the bottom of a depression, when the market value of capital invested in industry was generally far below the amount actually

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* Bullock, op. cit., p. 289.
† Ibid., p. 982.

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invested—thus the taxpayer was faced with the choice of paying a capital stock tax on a value that did not exist, or an excess profits tax on profits which were not excessive upon the test set forth in the law of what constituted an excess. It is hard to conceive of a tax device better calculated to bring the taxing system into disrepute.

In England, local taxation has for centuries been based on the annual value of property.* In national taxation the influence of the landowning classes was for a long time dominant, and prior to 1894 even death duties on land were levied only on the capitalized value of an annuity equal to the net rental value of the land for the life of the heir. In that year, however, land was subjected to death duties (estate duty) on the basis of its full capital value, at progressive rates which have since been greatly increased.† In 1909, a further step was taken. A system of taxation on the increment in land value was initiated, but the administrative difficulties proved so great that this experiment was abandoned. Thus, apart from transaction taxes, such as stamp duties on the transfer of property, death duties remain as the one case (of course, an important case) in which English taxes are levied on the basis of capital values.

The estimation of the capital value of land from the annual value, which is fostered by the English practice, serves a useful purpose in checking too optimistic valuation. Had this method of approach been general here, the disastrous Florida land boom could hardly have occurred, and fewer of our farmers would have found themselves ruined through acquiring by the use of borrowed money additional lands at prices out of proportion to the annual yield obtainable therefrom. A writer in the University of Pennsylvania Law Review for December, 1935, has suggested that there is a tendency today to give more weight to current annual value in establishing valuations of real property for purposes of local taxation.

Economic opinion on the theory of value in relation to rate regulation scarcely calls for comment, if that opinion is, as I

† These provisions were the subject of a sharp difference of opinion between the Prime Minister (Lord Rosebery) and the Chancellor of the Exchequer (Sir William Harcourt) who had been the rival candidates for the succession to Mr. Gladstone. It is interesting to find in the Chancellor's reply to the Prime Minister's criticism this comment:
"Your observations upon the American attempt at a property tax are well founded, but everybody admits the objections to a property tax, which is levied annually on the possessors do not apply to a death duty which occurs only once in a generation on the transmission of estates into other hands."
believe it to be, accurately summed up in the following quotation from J. C. Bonbright:

"I think I am speaking the truth when I say that every economist without a single exception agrees that whatever is the proper basis of rate control . . . that basis cannot logically be the value of the property . . . this country alone of all the countries in the world attempts to use valuation as a basis of rate control."*

I shall, however, discuss some special phases of the problem of regulation in my final article.

In the third field already mentioned, that of income taxation, economic opinion has not, I think, generally approved the taxation of capital gains as income, even though the practice has escaped the wholesale denunciation which has been visited on our systems of local taxation and rate regulation. For myself, I have long felt that though it may seem unfair that unearned increment should escape taxation while earned income is heavily taxed, the weight of the argument is against the taxation of capital gains. And I am still more opposed to the treatment of capital gains as income for purposes other than those of taxation—indeed, one of the minor objections to the taxation of such gains as income is that it encourages the taxpayer to treat them as income in ordering his own affairs, instead of adding them to his capital or holding them in reserve against the all too probable future capital loss.

In an article written in 1922†, I recited some of the reasons that led me to the conclusions which I still hold, and I shall now do no more than consider what further light on the question the events of the intervening years have afforded. They have shown that the tax operates to produce artificial markets for securities, by preventing sales which, but for the tax, would be made, and thus has tended to make the fall more violent when it comes. They have also demonstrated with disconcerting completeness the validity of the argument that an equitable tax, designed to give relief in respect of losses commensurate with the tax on gains will, on balance, adversely affect the revenue, and that the adverse effect will be felt when the revenue is least able to bear it. As a result, changes have been made in the law which implicitly admit that capital gains are not income but leave them

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subject to tax as if they were, changes which sacrifice justice to immediate revenue, through the continuation of the tax on net gains and the practical denial of relief in respect of net losses.

The new provisions, by which a portion of the gain on sale of assets held for a period of years is taxed as income at rates which are reached by adding that portion of the gain to what happens to be the income of the year in which the gain is realized, are difficult to justify upon any theory of ability to pay or equality of sacrifice, or upon any of the canons of sound taxation. The denial of allowances for losses on property sold is manifestly unjust and results in such absurdities as taxpayers being led to sacrifice substantial salvage values in order to preserve the right to take deductions for losses which are allowable if property is abandoned but not if it is sold. There is, moreover, something repugnant to one's sense of justice in the sight of a Government deliberately devaluing the currency and taxing the difference between the price received in depreciated currency and the price paid prior to devaluation in the undepreciated currency as a gain and at the same time denying to taxpayers relief in respect of losses occasioned by the fall in prices which is pleaded in justification of the devaluation.

The provisions of the law relating to non-taxable reorganizations and exchanges, and other provisions necessitated by the taxation of capital gains, are constantly adding to the complexities and uncertainties of taxation. Meanwhile, the great argument for the taxation of capital gains—that without it unearned increment would go untaxed—has been greatly weakened by the enactment of high gift and estate taxes.

The amount of capital gains spent as income though large in itself is small in comparison with the aggregate of such gains. If gains are offset by later losses, it is grossly unjust that heavy taxes should be levied on the gains with no compensating relief in respect of the losses; if they are added to capital, that capital is heavily taxed whenever it is transferred by gift or bequest.

Students of taxation have agreed that an income tax at high rates cannot long continue to be successfully levied unless the law is generally regarded as broadly just in its form and administration. It can not, I think, be maintained that this is true of our existing income tax system, and those who deny its justice can point to the provisions respecting capital gains and losses as striking evidence to support their position. It is inevitable that
The Influence of Accounting

provisions which the taxpayer regards as deliberately unfair shall encourage deliberate evasion; and even if it is true that evasion existed prior to the enactment of these unjust provisions this hardly seems sufficient ground for a policy of deliberate injustice on the part of the Legislature. Congress would be well advised to abandon the policy of taxing capital gains—or, if that is deemed to be politically impossible, to tax them as something other than income at a flat rate not high enough to act as a deterrent to the taking of profits. This could be done without awaiting the general revision of our federal tax system, which is so urgently needed.

Sooner or later, however, we must broaden the scheme of federal taxation, and particularly the basis of the income tax. Not until this has been done can we hope to enjoy the relative stability of revenue which England has experienced in spite of the depression and of the magnitude of its tax burden.

Turning from the tax aspect of the question of capital gain, I would draw attention to a danger against which some safeguards are, I think, urgently required. This danger arises from the alarming habit which seems to be developing of regarding every annual report as a new edition of a prospectus. Even those who contend that realized capital gains are a form of income must concede that such gains and recurrent income have no common relationship to earning capacity, except to the small extent that capital gains may represent recurring income that has not been distributed. Apart from this item, which for practical purposes may be disregarded, the gain normally represents either (a) the capitalized value of a change in capacity to earn recurring income (demonstrated or assumed); or (b) a change in the rate of capitalization applied to an unchanged earning capacity; or (c) a combination of the two. This being so, such a capital gain can not properly be added to a recurring earning capacity (which has not already been capitalized) to form the basis from which, by multiplication, a capital value may be determined. To my mind, few points are of more importance in connection with the problem of presenting illuminating reports to investors than that of taking some steps which will tend to prevent investors from including capital gains with current income in one sum, from which they will compute capital value by a single multiplication.

The treatment of capital gains as income reached its most pernicious development during the boom period in the practice of re-
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garding stock dividends as income in an amount equal to the market value of the stock, the evil being especially marked in the case of pyramided holding companies. To the extent that the amount included in income exceeded the amount of earnings which formed the basis of the distribution by the company declaring the dividend, the credit to income by the receiving company represented nothing except an unrealized capital appreciation. Another unsound practice is that of requiring investments of insurance companies to be carried in their reports at "market value" even if above cost. When market prices rise to dizzy heights, as in 1928–29, the assets of such companies as reported under the regulations rise with them. When prices fall too precipitately, however, the evidence of the market is rejected and artificial market prices are constructed by the Commissioners. The result in practice is, therefore, that the portfolios of what should be our safest and soundest institutions are carried at quoted market prices if those are very high but above market prices if those are very low. The fact that resort to artificial prices was deemed necessary three times within a quarter of a century suggests that the Commissioners should at least recognize the limited significance of market quotations when they are high as well as when they are low.

From the point of view of the technical accountant, it is a curious contradiction that we, who have gone further than any other country in refining double-entry bookkeeping and distributing charges over successive periods by elaborate systems of accrual, should in our thinking have, in effect, adhered to the old single-entry method of determining gain or income by deducting worth at the end of the period from worth at the beginning thereof.

Some of our economists and statisticians have even undertaken to include fluctuations in the value of the "national" capital in computations of the "national" income. In doing so, they have exaggerated the growth of wealth in boom periods and its decline in periods of depression with, as I think, unfortunate results. In a recent article, Sir Josiah Stamp commented on this procedure as follows:

"American writers have included the rise in the market value of capital assets under income (or the fall as a deduction), but the practice is not generally accepted in other countries." *

He went on to express the opinion that this was "all of a piece with the strange compound of capital charges and income in the American system of taxation". In fairness to American economists, however, it may be questioned whether the views which he criticized are shared by more than a small minority of them. In publishing his paper, he printed the following interesting footnote:

"On the day of reading, the latest official publication was received from Washington.* In this, the whole method has been abandoned: 'the inclusion of gains and losses yielded by such changes in asset values would be either a duplication, since it would amount to counting both a change in net income, and the change in capitalization of that income, or a distortion of the national income estimate as a measure of the economic system's end product.' It seems clear that the publication to the nation of figures of national income already heavily diminished, but reduced to a minus quantity by the special deduction of the huge shrinkage in capital values for 1932–3, was too much for any realistic official statisticians to face."

The preoccupation with capital and capital gains is also to be found in the securities legislation passed under the present administration, which is obviously, if unconsciously, framed in the interest of the short-time speculator for the rise rather than of the long-time investor for the yield. Even the members of the Securities Commission seem to have developed doubts on the question whether the acts were really necessary or will prove beneficial in relation to issues of securities by seasoned corporations. Further, some of the information which is required by the Commission in registration statements and annual reports would seem possibly to be helpful to speculators (though more clearly to competitors), but more likely to injure than to benefit the long-time investors, whose interests surely deserve special consideration.

It has seemed to me particularly unfortunate that at a time when devaluation, inflation, and apprehension of further experimentation with our fiscal system were impairing confidence in what had been regarded as high-grade securities and tempting small savers to gamble in equities, the whole emphasis of the Administration and of Congress should be upon efforts to diminish slightly the hazards of stock gambling, and none upon the magnitude of the hazards that were bound to remain.

* National Income, 1929–1932, Department of Commerce in cooperation with the National Bureau of Economic Research, Inc.
Granting the desirability of telling the public that great losses had been caused by the misdeeds of issuers and vendors of securities, it was at least equally desirable to tell the public that these losses were but a small fraction of those resulting from the financial, industrial and political hazards to which all business is subject, and that enormous losses on investment in enterprise and invention are a part of the price we must pay for progress. The two Securities Acts are calculated to create expectations which they can not satisfy; and although they may perhaps be made to serve a useful purpose, the hope would be stronger if the Acts had been less theoretical and punitive in conception, and had had more regard to what is remedial and practical. It lies in continued wise administration and judicious amendment rather than in the Acts themselves. Indeed, one of the dangers of the admitted excellence of administration by the Securities Commission up to the present time is that it may tend to blind us to the inherent defects of the law.

The same emphasis on capital value is, I think, also in large measure responsible for the laws passed in recent years making the propriety of dividends dependent on there being an excess of assets over liabilities and capital, thus displacing the old rule under which the source of income to a stockholder was the earning of a profit by the corporation in which he held stock, and the declaration of a dividend merely fixed the time when it became income to him. This change, whether desirable or undesirable, may obviously have very important economic consequences, particularly in conjunction with the no par value stock laws. If generally adopted, it would rob the word "dividend" of its old significance, since under it the payment of a dividend does not imply the previous earning of a profit and a dividend may be, in every real sense, a distribution of capital. Though perhaps the new law represents only an attempt to escape from the difficulties with which we are familiar without adequate thought of the new difficulties which may be encountered, to me it seems to be fraught with great possibilities of evil.

* I expressed substantially these views when securities legislation was pending, both in 1933 and 1934. In my testimony before the Senate Committee on Banking and Currency in 1934, I said:

"My feeling on this question, I think, must be very much that which the committee feels in regard to the larger subject. You want to do everything that you can to make buying and selling securities, particularly by the small man, safer and surrounded with more information. But you must realize that all you can do will not reduce the risks that he is bound to run very greatly, and there is always the danger that by legislating you create a feeling of confidence in the securities that are offered which legislation cannot possibly impart to them" (Hearings, p. 7176).
The Influence of Accounting

There was doubtless a time when the assets test was regarded as protecting the interests of creditors and necessary for that purpose; but with the law and common practice permitting legal capital to be fixed at nominal figures, such a rule adds little or nothing to the common proviso that no dividends shall be paid when a corporation is insolvent or when payment of the dividend would make it so. It is noteworthy that even this last provision is deemed unnecessary in England; it was in the English law of 1855, but was eliminated in 1862. Since then, apart from the general Statute of Frauds, the sole reliance in England for protection against improper dividends (and also against the acquisition by a corporation of its own capital stock) has been the section which sets forth the way, and the only way, in which the share capital may be reduced. This protection seems to have been adequate; no doubt its effectiveness has been increased by vigorous declarations such as that of Lord Campbell in *Burnes v. Pennell*, (1849): "Dividends are supposed to be paid out of profits only, and when directors order a dividend, to any given amount, without expressly saying so, they impliedly declare to the world that the company has made profits which justify such a dividend." This dictum is commonly reflected in articles of association in the form of a terse declaration that "No dividend shall be paid otherwise than out of profits."

In its new form (e.g., in Delaware), the assets test is, of course, nothing more than a device to permit directors to declare dividends when there are no profits. The power conferred by that law to make the legal capital of a corporation only a fraction of its economic capital makes such dividend declaration possible without insuring any substantial margin of protection to creditors.

An anomalous situation is presented by the New York law as at present construed by the courts of that state (the construction and the constitutionality of the provision, however, are at present involved in cases pending in the Court of Appeals of the State). It makes directors of a business corporation liable if they declare a dividend unless, after the declaration of the dividend, the value of the remaining assets is at least equal to the liabilities and the legal capital of the corporation. The elusive term "value" is not further defined, and as the law is at present construed, no defense of good faith or reasonable care will protect the director if it is subsequently found by a court of competent jurisdiction that
upon some theory of value accepted by it the value of the assets fell short of the required standard.

Now, in any such legislation, the relationship between the theories governing the definition of capital and the restriction of dividends is of the first importance. A rigid rule regarding dividends may be made tolerable by liberal rules defining capital. If the law seeks to make legal capital and actual capital correspond closely, then a dividend rule like New York’s becomes unreasonably harsh.

It is obvious that in the case of a company whose legal capital is approximately the same as its actual capital, such a law would subject directors to a hazard which they would not be warranted in assuming; a director could only vote at his peril for the distribution by way of dividends of unquestioned current earnings. New York, which took the leading part in adopting the questionable device of stocks without par value has, however, afforded domestic corporations an opportunity to make their legal capital a purely nominal figure which may be only a fraction of the true capital. This provision, while open to many objections, does afford a way in which the hazards of the dividend rule may be avoided.

However, the New York law goes further than to establish a rule applicable to domestic corporations—it imposes the same liability on directors of foreign corporations which transact business in New York. Now, outside the State of New York, and particularly outside the United States, there are many jurisdictions in which either the law or custom makes the legal capital substantially the true capital of the corporation and in which the law permits the distribution of current profits without regard to fluctuations in the value of capital assets not intended to be sold. Such an approach to the question is at least as reasonable as that of the State of New York, but it will be observed that the directors of a company formed in such a jurisdiction, but transacting business in New York, are placed in a peculiarly unhappy position. For the capital of the corporation will be determined by the laws of the jurisdiction in which it is incorporated, but the question whether a dividend paid was warranted will be determined by a New York court, under New York law, and upon New York theories of value. The law so construed seems to constitute an obnoxious attempt to impose New York ideas of questionable soundness upon corporations formed in other jurisdic-
tions but transacting business within the state. If the Court of Appeals sustains the current construction, modification of the law would seem to be called for.

In each of the several fields which have been considered, the habit of thinking in terms of capital value seems to me to have encouraged economic tendencies which are harmful to the community. It is clear, also, that while it is seldom possible to determine annual income precisely, and sometimes difficult to arrive at even an approximation thereto, the problem of determining income is easier than that of establishing capital value. This for the simple reason that value, itself, must be dependent mainly on the income prospects; and in order to measure it, we must first estimate earnings. Then we still have to face the difficulty of determining what is the capital value of an earning capacity of the kind with which we are dealing.

Economists, teachers, legislators and accountants should all do what is in their power to bring home to our people the truth of Adam Smith's doctrine that the annual produce constitutes the wealth of the country; and to encourage them to rely for economic security on the income derived from their work and their property, rather than upon the hope of enhancement of capital value, which may seem to offer the easy road to affluence but more often proves a lure to disaster. Then the Economist may no longer be able to say as it did on October twelfth last that:

"Even today, in spite of depression and Securities Acts, the capital profit is still as completely monarch in Wall Street as the income yield is in Throgmorton Street."
A School of Professional Accountancy

By Roswell C. McCrea and Roy B. Kester

The 1929 amendment to the education laws of the state of New York provides that "subsequent to January 1, 1938, every candidate for examination for a certificate as a certified public accountant should present evidence that he has satisfactorily completed the course of study in a college or school of accountancy registered by the department, as maintaining a satisfactory standard and that prior to the beginning of his course of study in a college or school of accountancy, he satisfactorily complete a four-year high-school course, approved for this purpose, or the equivalent, as determined by the commissioner of education."

This amendment, sponsored by the accounting profession in the state of New York was indicative of the feeling that previous educational requirements for those expecting to enter the profession were entirely inadequate. Previous to 1929 the C. P. A. laws of the different states required nothing more than graduation from a high school or its equivalent. So far as I know, New York is the only state which has indicated its intention of raising the educational standards for those seeking its certification for the practice of public accountancy. With the financial center of the country and its related services located in New York, this action is significant of the appreciation by professional accountants of the need for better and more broadly trained men to handle successfully the increasingly important tasks which accountants are being asked to perform. The lead taken by New York in this matter will, in my opinion, in the course of the next few years, be followed by most of the states in the union.

Brief Historical Survey of Education for Accountancy

This action by New York has been of particular interest to school men, in that it has caused a careful examination to be made of the status of regularly organized programs of education for professional accountancy. It may be noted here that, whereas for many years there have been separate schools for law, medicine, engineering, architecture, etc., for the training of men planning to enter those professions, collegiate education for the accountancy profession has been cared for by schools of business, in which the
courses in accountancy have been required to serve more than a single purpose. It is interesting to note that the program of the Wharton School of Finance and Commerce, established in 1881 at the University of Pennsylvania, contained no provision for the teaching of a course in accounting. The course of study at Wharton School at that time was a two-year course based on two years of study of the liberal arts. This was changed and the course broadened in 1894, when the four years of study were placed more nearly under the control of the Wharton School staff. By this time a course in elementary accounting had been added and one or two other accounting courses were offered.

In 1898 the University of California and the University of Chicago established schools of business. In 1900 Tuck School at Dartmouth College, the School of Commerce, Accounts and Finance at New York University, and the School of Commerce at the University of Wisconsin were established. Schools of business at the University of Michigan in 1901 and at Harvard University in 1908 followed; and the School of Business established at Columbia University in 1916 became the eighteenth in a procession which has since expanded to amazing length within a couple of decades.

Immediately, or soon after the organization of these schools, provision was made for the teaching of courses in accounting. These were looked upon as basic courses to be prescribed for all students whether especially interested in accounting or in other fields of business endeavor. Previous to and during this same period, private commercial colleges offered courses in bookkeeping and accounting. As the demand for professional accountants increased the offering of these schools was considerably extended. Also during this period a number of private schools offering instruction by correspondence came into existence. For a considerable time the training offered by some of these schools was as good from the standpoint of subject matter as anything offered by resident schools, either privately owned or of collegiate rank.

As the years have gone by and the work of the profession has increased in importance, many of the collegiate schools, where there has been demand for specialized training in accounting, have increased their offering of accounting courses, until today several schools—particularly those in the larger centers—offer preparation nearly approaching that for the older professions. In most schools, however, which are attempting to give some training for
professional accountancy, the extent of the offering is wholly inadequate and the facilities by way of faculty personnel and library and laboratory are of very low grade. The result is that the standard of work offered by such schools does not nearly approach that given by the professional schools of law, medicine, engineering, etc. As evidence of this situation one need only look at the specific requirements set up in New York for judging the adequacy of training for students for admission to the state board examination for certified public accountant. While the educational requirement is for graduation from a four-year college course after completion of the regular high-school work, the specific technical requirement covering both accounting and related business subjects comprises only about one and a half years of the four. This technical requirement is as follows:

<table>
<thead>
<tr>
<th>Subject</th>
<th>Hours</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting</td>
<td>24</td>
</tr>
<tr>
<td>Business law</td>
<td>8</td>
</tr>
<tr>
<td>Finance</td>
<td>8</td>
</tr>
<tr>
<td>Economics</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>46</strong></td>
</tr>
</tbody>
</table>

The four-year course of study as measured in semester hours constitutes usually a minimum of 120, i.e., an average minimum of 30 semester hours per annum. When one compares this educational requirement with that of schools of law, where usually the course covers a minimum of five years of work of collegiate grade, of which three—i.e., approximately 90 semester hours—are devoted to technical courses in law, the inadequacy of the comparatively high requirement of New York becomes apparent. However, in appraising the action taken by New York, account must be taken of the present status of educational facilities on which the profession must draw for its new blood. Thus, while recognizing it as considerably short of an ideal requirement, we must appraise the action as a forward step of real significance.

**The Work of the Professional Accountant**

When one considers the type of work demanded of the professional accountant today, particularly so far as it concerns the various uses to which his work is put and the large number of government bureaus, businesses and persons who depend upon his work as a basis for their own activities, one may well question whether even a period of four years of college work offers adequate
preparation for the type of men who should be concerned professionally about these matters.

Today the work of the professional accountant is involved pretty largely with the preparation of the following types of materials:

1. The preparation of certified statements of financial condition and operating results for use in the annual reports of corporations to their stockholders.
2. Preparation of reports used as a basis for commercial credit.
3. Reports used as a basis for new financing by the sale of bonds and stock.
4. Reports used as a basis for taxes due governments.
5. Reports to courts covering the handling of estates by executors and trustees.
6. Certifications, based on audits, covering the administration of municipal and other governmental executives.
7. Reports to serve as the basis for purchase or sale of businesses.
8. Reports to serve as a fact finding basis for adjudications in court.

The importance and value of the type of work indicated by this brief summary is evidence of the calibre of professional ability required. While professional accounting is one of the newer professions, its roots reach probably as far back into the past as those of the legal profession, and today the substantial quality and importance of the work performed by the accounting profession measures up well with that expected of the legal profession. Furthermore, because of the breadth of the field of business, which is limited only by the extent of human endeavor in the satisfaction of economic wants, the accountant is required to be familiar with a broader field than, probably, is the lawyer. A course of training, therefore, equal in intensiveness and extent to that of the law would seem to be a minimum requirement for the professional accountant.

It is with this general appreciation of the growing importance and extent of the professional accountant’s work today that the new course of training for professional accountants was set up by the school of business at Columbia University. In organizing this course of study, it was recognized that a great deal more is de-
manded by the profession today than a mere knowledge of technical methodology. It is true that those who enter the profession today must be better trained technically than at any former time, but, in addition, they must be men of a type we have come to expect professional men to be. They must have a broad cultural background which should give them an appreciation of their responsibilities to society and the state. On that cultural foundation there must be built a knowledge of the broad field of business and economics, and superimposed on that must be the technical training in their chosen field. And this plan of education must be tied together and vitalized by a recognition of its interrelations, an appreciation that it is a coördinated whole.

Cultural Background

While the term "culture" may have a variety of meanings to different persons, it is generally recognized that every young man, particularly one who expects to enter a profession, should have a sufficiently broad knowledge of the so-called arts and sciences to give him a proper appreciation of present-day civilization. He should know the major scientific facts about the world he lives in and should have an appreciation of the richer fruits of civilization, usually known as the fine or liberal arts. He should have some knowledge of the trends of present civilization, particularly as it is related to civic and governmental affairs. He should have acquired the ability to meet his fellow man on an equal footing, and he should be able to express his thoughts clearly and forcefully in his mother tongue.

The acquisition of such a cultural background is not possible within the four-year period of the high-school course. In these days of the broadening of the field of human knowledge, two years of work in a liberal-arts college suggests itself as the minimum feasible period; and the result even on this level, we must recognize, turns as much on the human material we attempt to shape as on the devices through which we attempt to do the shaping.

General Business Knowledge

It might seem that since so much of present-day professional work of all kinds is concerned with the field of business, every professional man, whatever his specialized field, should have at least a general knowledge of business. Exception can hardly be taken to such a requirement, but it is particularly pertinent to the pro-
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Professional accountant whose field of endeavor is the workshop of business. The data which he uses, the phenomena which he must analyze are for the most part drawn exclusively from the field of business. His work and technical equipment must, therefore, presuppose a general knowledge of business endeavor and the way in which business is carried on. This knowledge should cover at least the following divisions of the field:

1. The broad types of the legal organization of business, such as the single proprietorship, the partnership, the corporation, the holding company, etc.
2. The way in which business organizes itself internally to carry on its various activities, such as merchandising.
3. The main economic and management problems inherent in the functional operating organization of business.
4. The relationships of business to society as a whole, involving governmental controls, tariff and tax policies, quality of product, codes of fair practice, etc.

Inasmuch as the broader aspects of accounting are "tied in" so closely with business practice, it is particularly appropriate that general training in such practice should form an integral part of the professional training course of the accountant rather than that it should be set up as a separate unit prerequisite to entrance upon that course. This portion of his training takes on added significance and interest to him when related specifically to the practical phases of his profession.

Knowledge of the Technical Field

It is superfluous to state that a student intending to enter the field of professional accountancy should have a knowledge of his field. However, for the practice of any profession two things are necessary:

1. The practitioner must know intimately the field and the science underlying it.
2. He must have an intimate knowledge of the tools of his profession.

Professional practice of any kind is an art resting upon a body of organized knowledge that may well be called a science. Young men entering the accounting field, therefore, must know the extent of the field of practice and the basic principles on which practice must rest, and they must also have certain facility in the application of those principles to specific cases. In addition to
knowledge of these two kinds they must be conversant with the ethical and legal standards in accordance with which professional men govern themselves. Their specific technical training, therefore, must cover these three constituents:

1. Subject matter
2. Methodology
3. Standards of professional practice

THE COURSE OF STUDY

Attempt has been made above to set forth in general terms the educational preparation necessary for the practice of professional accountancy. It may be well to indicate somewhat more specifically just what that training should comprise. From what has been said above, it is apparent that the minimum requirement may well be looked upon as a five-year course of study beyond graduation from the usual high-school course. Of these five years, two will be spent in a liberal-arts college as a preliminary period, the purpose of which is to provide a grounding in the arts and sciences looked upon as essential to a well educated man. As law, medicine, engineering and architecture have set up such a two-year period as a minimum, accountancy should do no less. In this two-year period the usual courses in modern foreign language, history, economics, and English composition and literature will form a large part. In addition, room should be found for courses in commercial geography and at least one year of mathematics, particularly a course in algebraic analysis. These two years will provide the cultural foundation on which to build the necessary technical training.

As mentioned above, the technical training must provide for foundational courses in business practice and management and technical courses in the science of accounting and its practice. Relatively about one-fourth of the three years' work should be devoted to general business practice and management and three-quarters to courses in technical accounting. To provide the necessary knowledge of business, specific courses in business organization and management, money and banking, corporation finance, principles of marketing, and even in personnel management and insurance may well be pursued. The tool subject of statistics, comprising statistical method and interpretation, and business practice as governed by law should also be included.
The technical accounting courses should cover the following subjects:

1. Principles of accounting, to which, of course, several separate courses will be devoted, the function of which is the presentation of the organized principles of the subject matter of the field.

2. Auditing, which is essentially a tool subject, the purpose of which is to present the methodology to be used in the application of the principles of accounting to specific cases; the purpose of the course being the presentation of the principles of audit in accordance with which the correctness of the record can be established. A separate course, and probably the most important single one in the entire curriculum, will concern itself with the application of these principles of audit to given situations met in the practice of public accountancy. Specialized materials become highly necessary for this course.

3. A course or courses treating of the organization and presentation of materials in report form and the interpretation of such reports. The accountant's findings to be of proper value must be presented to his client in easily understandable form. While from a functional standpoint it may not be the duty of the accountant to interpret (responsibility for that resting on the executive for whom the report is drafted), yet the professional accountant increases his value to his client many fold if he is able to point out the meaning of his report, so far as it relates to the business policy to be followed as a result of that report.

4. A course dealing with the installation and operation of accounting systems, including the development of the chart of accounts, the suitable underlying records, such as business papers, memoranda and books of account, the installation and the supervision of the system.

5. A course dealing with the business aspects of professional accounting practice. Such a course should deal with such problems as the organization of the professional office, the staff personnel, its classification and handling, business contacts with clients, the legal aspects of professional partnerships and the ethical standards of the profession.
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In the past in too many schools—and to too great a degree at the present time—accounting has been taught more from the standpoint of the mechanics or technique of the art rather than from that of the science on which the art rests. There has been too much emphasis placed on the "how" and too little on the "why." Accounting is so intimately related to the entire field of business; its practice and its procedures are so closely tied up with law, economics, banking and finance, that its intelligent practice must rest upon a broad knowledge of these several allied fields. While there may be justification for the presentation of courses from the standpoint of technique rather than from the standpoint of the philosophy on which that technique rests in schools where accounting is looked upon simply as a tool subject suitable for the student of general business, no place can be given to that method in a school of professional accountancy. Accountancy as a science will always be in a state of flux, ready to adapt its laws and principles to the needs of the business society and the civilization in which it functions. While certain very fundamental and basic concepts can be traced from the beginning of professional accountancy to the present time, the applications of those principles and concepts have varied greatly over the years, changing emphasis being placed on certain phases in accordance with changes in the requirement to which the use of accounting service is put. It is due mainly to this conception and appreciation of the place of accounting in the business economy, that no young man may be considered qualified to go far in the professional practice unless in the course of his education he has developed the philosophy on which that practice must rest.

Methods of approach to the problems encountered in the practice of accountancy, devices for analysis, the weighing of all of the many factors—civic, financial, legal, economic and moral—which must be taken into account before a proper accounting policy can be determined—all of these things must be made a part of the equipment of the man who today is looking forward to a professional life of high attainment in the accountancy field. To accomplish this end, the instructional work must deal not only with the principles of philosophy or theories of accounting, but these must be related to specific cases to show their various and varying applications. This can not be accomplished except by the use of the case and problem method.
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The subject matter of technical courses in accounting must, therefore, comprise something more than the bare skeleton of technical accounting. While technique is quite necessary as a framework, it must be vitalized by an appreciation and understanding of the business problems in the solution of which it is used and of the business policies, the formulation of which is so largely dependent on the information afforded by the accounting process. At least half of the instructional matter presented in the training course for professional accountancy should be devoted to material of this kind.

Basic Needs

It is probably not necessary to point out that a professional school must have adequate equipment and personnel. A faculty of high scholarship, laboratories and libraries available for practice and research, and teaching materials covering practice and problem work must be provided. Without specialists who are sufficiently in contact with the professional field to know its needs and its trends and development, no school should ever attempt professional training.

In our present venture at Columbia this aspect has not been ignored. The level of our objective is reflected in the constitution of an advisory board made up as follows: Archibald Bowman, Arthur H. Carter, Paul K. Knight, George O. May, Robert H. Montgomery, and Arthur Young.

Selection of Students

The facilities of a professional school should never be opened indiscriminately to all who may desire to enter. A school which offers training for a specialized career, by the very fact of offering, assumes a responsibility to do everything in its power to choose only those who will be found suited to that profession. Tests and methods of selection must be devised and applied not with mechanical exactitude, but always with an appreciation of the latitude of error inherent in human tests.

Some attempt must be made to evaluate the physical, mental, moral and personal qualifications of every applicant. Qualities of physical well-being and personality are susceptible of some testing by sight. Something of the background of the applicant as to health, family and social life may sometimes be helpful. Mentality can be judged within limits by means of tests but better
by means of previous-performance records in school. The content of the student's course, the character of his ratings as indicative of current or latent interests and mental qualities should be depended upon to a large degree. The testing of his moral fiber is probably the most difficult. While by looking at a man it is usually impossible to determine these characteristics, particularly his reactions in this regard in circumstances and situations of life to which he has not yet been subjected, letters from those who have been in charge of his previous training constitute probably the best estimate of moral stamina and honor which it is possible to secure. The ethics of the profession which he is about to enter rest upon personal qualities of honesty and honor which it is difficult to measure. Other qualities such as will-power, patience, imagination and common sense, which means a balanced attitude towards life, are all incapable of exact measurement, but some attempt should be made to secure ratings on these points. His prospective success in the profession and his immediate employability rest upon these factors.

PROFESSIONAL TRAINING IN ACCOUNTANCY AT COLUMBIA

Effective for the school year 1936-37, there is being established within the administrative framework of the School of Business at Columbia University a "college of accountancy," as the 1929 education law of the state of New York phrases it, granting the professional degree of "master of science in professional accountancy." The course of study will cover a three-year course of technical training based upon a two-year course in a college of liberal arts. The basic plan of professional education at Columbia requires all students to take at least the first two years of training beyond the high school in a liberal-arts college for the purpose of securing a broad outlook on contemporary life and a comprehensive survey of the elements of present-day civilization, of which they are a part, and of the historical background of that civilization. The new course of study conforms to this general plan, requiring the completion of five years of study beyond high school. These three years of specialized study will comprise basic courses in business, economics, law, finance and banking, in addition to the technical courses in accounting. The technical courses are presented not only with the purpose of training in the necessary techniques of the profession, but also with the purpose of giving them a broad setting, showing their interrelations with gen-
eral business economy, with due regard to relevant principles of economics and business practice.

Only those who have shown aptitude in the use of figures and figure analysis and of interpretative processes will be admitted. Prospective employability of the student upon completion of the course is a determinative factor. Our venture will regularly be kept flexible and adaptable in its detailed requirements, and its objective will steadily be shaped in terms of the social utility of our effort.
Accounting for Profits and Losses on Foreign Exchange for 1935

By Edwin L. Lopata

In 1934 most American corporations, because of exchange restrictions, were forced to acknowledge the impossibility of remitting funds from many foreign countries. As a result there was a complete shift from official rates of foreign exchange which had been used for the conversion of the current section of the balance-sheet at the end of 1933 to open market rates at the end of 1934. It is believed that when the government regulates exchange markets from day to day, with rigid supervision over the transfer of funds, the only acceptable procedure must be the use of market rates. When it is necessary for a government to manage foreign exchange it is apparent that there are difficulties internal, international, or both. Such weaknesses are too often followed by a depreciation of the currency of the country.

As long as most of the world remains off the gold standard, business probably will have to contend with continually shifting foreign exchange rates. Stabilization in the near future is admitted to be doubtful. It may take many years before internal price levels will have been adjusted sufficiently in all countries to effect any satisfactory stabilization. It seems, therefore, that the disposition of exchange losses and gains in ordinary operations and on conversion of balance-sheets is to be a perennially recurrent problem. Corporations would do well to review their foreign-exchange accounting policies so that their own practices may be uniform during the ensuing years. The practice of switching from one theory to another according to which theory fits the annual statement most decorously is to be condemned. Control and comparison are thereby impaired.

In discussing the practices prevalent in accounting for foreign currency items during 1935, it is well to begin with a description of the bases used for conversion. In all of the following discussion, data were taken, whenever possible, from the form 10 (or, as amended, form 8) of the company, on file with the securities exchange commission. In several instances annual reports were used.

Current assets and liabilities (of the thirty companies reviewed—their names appear in the tables on following pages) are gener-
ally converted at the current market rate at the end of the year. Several exceptions to this policy should be mentioned.

The International Harvester Co. converts its current items "on the basis of the rates used by the companies at Dec. 31, 1932, (except inventories which are partially on the basis of the United States dollar value of merchandise shipped from the United States). The rates used by the companies at Dec. 31, 1932, were the prevailing market rates at that date or slightly lower."

The company explains that the 1932 rates are used pending the stabilization of international exchange. In this way it eliminates all unrealized exchange appreciation and all unrealized market recoveries of exchange write-downs made in 1932 and prior years.

In addition to converting its current items at current rates the Goodyear Company converts preferred stock and funded debt in the hands of the public at current rates.

The B. F. Goodrich Company introduces a variation wherever inventories have been manufactured abroad and exchange fluctuations have been wide. It follows the principle, then, of "treating the currency at its equivalent in dollars and cents at the time of manufacture."

Standard Oil of New Jersey gives as its basis of conversion the following principles:

"Net current assets exclusive of inventories were converted at year-end rates of exchange after giving effect to forward exchange contracts. Cost of inventories purchased on a dollar basis was computed at the dollar cost to the foreign subsidiary, and cost of other inventories was computed at the dollar cost determined by converting foreign currencies at average rates of exchange over the period of accumulation. Inventories are at the lower of cost, so determined, or market."

A final exception to the general rule is the National Cash Register Company, which converts its inventories at dollar cost.

There is little need for comment when such a unanimity of opinion exists. It seems that current rates of exchange should be used to convert all current amounts on the balance-sheet. An objection must be lodged, however, to the inclusion of inventories at this rate in all instances. The current practice is based on the assumption that the goods and services are sold in a competitive market where prices do not change with fluctuations in exchange rates. This assumption does not hold good for many staple raw materials which move in international trade, especially when one
country possesses a monopoly of supply. Nor may it be valid when any element of monopoly is present; that is, monopoly of service, design, good-will, etc. Therefore, if a condition exists wherein the prices of goods in a foreign market are raised as soon as the foreign rates suffer any measurable decline, an increase in operating profits results and embellishes the record of the foreign-branch managers. Concurrently, a loss on foreign exchange is recorded upon conversion of the balance-sheet.

In such a situation it may be propitious to make an adjustment to present the facts of the situation. At the time selling prices are raised in the foreign country—due to exchange depreciation—the foreign branch or subsidiary could be required to write up the value of that part of its inventory acquired at prior rates, crediting a suspense account against which could be charged the unrealized loss on the intercompany account upon conversion of the balance-sheet. The greatest value to which the inventory should be raised would be the quotation of similar goods at current prices.

The bases of conversion of fixed assets and liabilities are stated in more or less the same manner throughout all of the statements—either at rates prevailing on the dates of acquisition or at average rates at which the assets are carried. Reserves for depreciation on fixed assets are converted at the rates of conversion of the fixed assets. The Chrysler Corporation varies this by converting its assets at the former par of exchange. A problem presented by this practice is discussed under conversion of depreciation expense.

No one basis of conversion of profit-and-loss items is generally accepted. The table on the following page shows those bases which are clearly stated by companies whose forms 10 were examined. Each basis used probably arrives at satisfactory results, yet the selection of one or the other affects the distribution between profits or losses from operations and exchange profits or losses resulting from conversion of the balance-sheet.

The selection of a basis for conversion of profit-and-loss accounts is dependent in part on the concept a company has of the time that operating profits are earned and in part on what it includes in gross operating profits (as well as to the position of the company and the type of business in which it is engaged). If the company feels that only profits should be shown as arising from operations which are actually made available to the parent company—and something may be said for this argument—remit-
Accounting for Profits and Losses on Foreign Exchange

tance rates will prove effective. If it feels that profits are to be recorded as realized from operations at the time the subsidiary earns them—and something may be said for this thesis—average rates of a period will prove effective. If average rates are used, and remittance rates are higher than average rates, the company will show a realized exchange gain upon remittance. However, if remittance rates (which are greater than the average rates at which profits were earned) are used for conversion, the operating profit (above the profit that would have been shown by the use of average rates) will be inflated by the amount gained as a result of a rise in exchange rates between the time the profits were earned and the time they were remitted. This principle is valid whether

Bases Used by Various American Corporations for Conversion of Profit-and-Loss Accounts of Foreign Branches and Subsidiaries

<table>
<thead>
<tr>
<th>Name of company</th>
<th>Basis used</th>
</tr>
</thead>
<tbody>
<tr>
<td>(abbr.)</td>
<td>Average rates Current rates Others</td>
</tr>
<tr>
<td></td>
<td>for year accumulated monthly</td>
</tr>
<tr>
<td>Am. &amp; For. Power..........</td>
<td></td>
</tr>
<tr>
<td>Am. Rad. &amp; Std. San. Corp.</td>
<td></td>
</tr>
<tr>
<td>Atlantic Ref. Co..........</td>
<td>***</td>
</tr>
<tr>
<td>The Borden Co.............</td>
<td>***</td>
</tr>
<tr>
<td>Chrysler Corp.............</td>
<td>***</td>
</tr>
<tr>
<td>Consolidated Oil..........</td>
<td>***</td>
</tr>
<tr>
<td>Eastman Kodak.............</td>
<td>***</td>
</tr>
<tr>
<td>Fox Film...................</td>
<td>***</td>
</tr>
<tr>
<td>General Motors............</td>
<td>***</td>
</tr>
<tr>
<td>Goodrich...................</td>
<td>***</td>
</tr>
<tr>
<td>Goodyear...................</td>
<td>***</td>
</tr>
<tr>
<td>Int. Harvester............</td>
<td>***</td>
</tr>
<tr>
<td>Int. Nickel................</td>
<td>***</td>
</tr>
<tr>
<td>Int. Tel. &amp; Tel...........</td>
<td>***</td>
</tr>
<tr>
<td>Radio Corp. of Am..........</td>
<td>***</td>
</tr>
<tr>
<td>Socony-Vacuum.............</td>
<td>***</td>
</tr>
<tr>
<td>Standard Oil (N. J.).....</td>
<td>***</td>
</tr>
<tr>
<td>The Texas Corp............</td>
<td>***</td>
</tr>
<tr>
<td>Union Carbide.............</td>
<td>***</td>
</tr>
<tr>
<td>United Fruit..............</td>
<td>***</td>
</tr>
</tbody>
</table>

Note.—Standard Oil (N. J.)—"The net income of foreign subsidiary companies to the extent of dividend remittances during the year has been converted into dollars at the rates of exchange current when the dividends were paid. With respect to profits not remitted in the form of dividends during the year, the net income before depreciation, depletion, amortization and retirements was in general converted into dollars at year-end rates of exchange, and from the amount so obtained there were deducted depreciation, depletion, amortization and retirements based on the dollar figures of fixed (capital) assets . . . ."
the remittance is in the nature of dividends or payment of inter-
company account.

The converse may be shown where remittance rates are lower
than the average rates at which the operations were conducted.

The bases used by American companies for converting depre-
ciation seem bound to result in some distortion of the operations of
foreign branches and subsidiaries. In every instance depreciation
is converted either at the foreign-exchange rates prevailing when
the fixed assets were acquired or at the former par of exchange.
Where the exchanges have fallen or risen to a permanent level
substantially different from that prevailing at the time the assets
were acquired and the assets have not been revalued on the basis
of the new exchange rates, a capital loss is camouflaged.

Alternatives are suggested for meeting this situation. Their
acceptance depends upon the underlying philosophy of the man-
agement. If the management feels that the dollar cost to the
subsidiary must remain constant, the assets should be written up
on the books of the subsidiary, in the terms of the foreign cur-
rency. With depreciation then being converted at the same rate
as other expenses, the subsidiary will show the same operating
profit that the parent company discloses on converting the state-
ment of profit and loss. On the other hand, if the company feels
that the value of the fixed assets remains the same for the sub-
sidiary in terms of the foreign currency, and if the subsidiary
actually makes a profit each year—which will be eliminated if
the parent company converts depreciation at the rate prevail-
ing at the date of acquisition of the asset—the parent company
should record a capital loss due to devaluation (or whatever the
cause) and convert depreciation at the rate used for other
expenses.

The phase of accounting for foreign currency items which
shows the most variation between companies is that which deals
with the treatment of realized and unrealized gains and losses on
exchange in remitting funds and converting the balance-sheet.
Several practices are prevalent.

The setting up of a reserve for exchange fluctuations seems to
have achieved more following than any other treatment of ex-
change gains and losses. Both realized and unrealized gains
and losses are recorded in this account. Of the 30 policies stud-
ied\(^4\) (picked at random from those concerns which might be ex-
pected to engage in foreign business) nine, or thirty per cent.,
generally make use of the reserve method. They include the following companies:

<table>
<thead>
<tr>
<th>Name of company</th>
<th>Source of data</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Radiator &amp; Standard Sanitary Corporation</td>
<td>Form 8</td>
</tr>
<tr>
<td>Chrysler Corporation</td>
<td>Form 10</td>
</tr>
<tr>
<td>Consolidated Oil Corporation (note 5)</td>
<td>Form 8</td>
</tr>
<tr>
<td>Corn Products Refining Company</td>
<td>Report for 1934</td>
</tr>
<tr>
<td>The International Nickel Company of Canada</td>
<td>Form 10</td>
</tr>
<tr>
<td>International Telephone &amp; Telegraph Corporation</td>
<td>Form 10</td>
</tr>
<tr>
<td>Radio Corporation of America</td>
<td>Form 10</td>
</tr>
<tr>
<td>Standard Oil Co. (N. J.) (note 6)</td>
<td>Form 8</td>
</tr>
<tr>
<td>F. W. Woolworth Co. (N. Y.)</td>
<td>Form 8</td>
</tr>
</tbody>
</table>

It has been rather difficult in each case to determine definitely that the concerns in the next class have closed their exchange gains and losses to consolidated or earned surplus, yet such seems to have been the case. This reflects a feeling that fluctuations in exchanges are a thing apart from current operations of the business and should not be reflected in statements of current earnings. 7

<table>
<thead>
<tr>
<th>Name of company</th>
<th>Source of data</th>
</tr>
</thead>
<tbody>
<tr>
<td>American &amp; Foreign Power Company, Inc.</td>
<td>Form 8</td>
</tr>
<tr>
<td>Armstrong Cork Company</td>
<td>Report for 1934</td>
</tr>
<tr>
<td>The Procter &amp; Gamble Company</td>
<td>Report, June 30, 1933</td>
</tr>
<tr>
<td>Union Carbide and Carbon Corp.</td>
<td>Form 10</td>
</tr>
<tr>
<td>Westinghouse Electric &amp; Manufacturing Company (note 8)</td>
<td>Form 10</td>
</tr>
</tbody>
</table>

In harmony with a desire to reflect all variations in foreign exchange rates as part of operations, the following companies seem to carry gains and losses to income, regarding the exchange factor as an integral part of operations:

<table>
<thead>
<tr>
<th>Name of company</th>
<th>Source of data</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Atlantic Refining Company</td>
<td>Form 10</td>
</tr>
<tr>
<td>International Harvester Company</td>
<td>Form 8</td>
</tr>
<tr>
<td>International Paper and Power Co.</td>
<td>Report for 1934</td>
</tr>
<tr>
<td>Socony-Vacuum Oil Company, Inc.</td>
<td>Form 10</td>
</tr>
<tr>
<td>The Texas Corporation</td>
<td>Report for 1934</td>
</tr>
</tbody>
</table>

Another procedure which has some measure of popularity is that which attempts to show exchange fluctuations as part of current operations but avoids the unacceptable practice of carrying unrealized gains to income. The following companies generally charge all losses, realized or unrealized, to income. They credit income with all realized gains but hold unrealized gains in reserve. When unrealized gains become realized, it is assumed
that they are transferred from the reserve to income. The clearest declaration of this policy is that of the Goodrich Company. In form 10 it states:

"The net profit or loss on foreign exchange is taken up when the transaction is completed. However, profits not realized on foreign exchange items are held in reserve on the balance-sheet and not taken into profit-and-loss account. On the other hand any anticipated loss based on the method of valuation set out under the balance-sheet notes is taken into the profit-and-loss account. This charge, therefore, represents realized and anticipated losses, less realized gains."

The companies generally following the same procedure as Goodrich are:

<table>
<thead>
<tr>
<th>Name of company</th>
<th>Source of data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastman Kodak Company</td>
<td>Form 10 and 1934 Report</td>
</tr>
<tr>
<td>General Motors Corporation</td>
<td>Form 10</td>
</tr>
<tr>
<td>The B. F. Goodrich Company</td>
<td>Form 10</td>
</tr>
<tr>
<td>The Goodyear Tire &amp; Rubber Company</td>
<td>Form 8</td>
</tr>
</tbody>
</table>

A fifth practice is one in which all profits and losses are closed to income, with the establishment of a reserve against which may be charged losses of an extraordinary nature—such as those which would result from the devaluation of its currency by a foreign nation. The sources of the reserves can not be ascertained easily, but in all probability they were created in former years when exceptional gains on exchange were recorded. Companies seeming to follow this practice are:

<table>
<thead>
<tr>
<th>Name of company</th>
<th>Source of data</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Borden Company (note 9)</td>
<td>Form 10</td>
</tr>
<tr>
<td>The Firestone Tire &amp; Rubber Company (note 10)</td>
<td>Report for 1933</td>
</tr>
<tr>
<td>Fox Film Corporation (note 11)</td>
<td>Form 10</td>
</tr>
<tr>
<td>The National Cash Register Company (note 12)</td>
<td>Form 8</td>
</tr>
<tr>
<td>United Fruit Company</td>
<td>Form 10</td>
</tr>
</tbody>
</table>

Finally, the two remaining companies of the thirty examined adopted the following programs:

E. I. Dupont de Nemours and Co., in form 10, state, "For purposes of conservatism . . . the equities in the undistributed earnings or losses of certain foreign controlled companies not wholly owned were determined on the basis of converting the accounts of such companies at approximately the exchange rate prevailing when the dollar investment was originally made some years ago." (This statement, of course, does not disclose the treatment of gains and losses.)
Accounting for Profits and Losses on Foreign Exchange

The Western Union Telegraph Co., in its annual report for 1934, explained, "Values of the company's current assets and liabilities abroad, mostly in Great Britain, are included in the balance-sheet on the basis of the rate of sterling exchange ruling at the end of 1934 . . . The change since December 31, 1933, in the value of the pound sterling in terms of the dollar accounts for the decrease in deferred non-interest bearing liabilities."

In defense of the multiplicity of procedures adopted, it should be noted that in all probability the selection of one basis or another by companies has been due to the nature of their businesses, and the exigencies of the situations in which they find themselves at various times. While no definite statement can be made on the subject, several conclusions are presented in the following pages.

The nature of foreign business implies that exchange gains and losses should be computed as part of the results of each transaction. No concern would be willing, other things being equal, to conduct operations in a foreign country from which no funds could ever be removed. Nor would it be apt to continue operations if each transaction were characterized by a loss on the transfer of funds, a loss great enough to wipe out the entire net profit. Hence, accounting practice should attempt to carry exchange profits and losses to income wherever possible. Fourteen of the thirty accounting policies investigated, the third, fourth and fifth groups outlined heretofore, follow variations of this policy. I feel that, wherever possible, gains and losses should be credited and charged to profit-and-loss, for the reasons stated above. However, the most desirable practice, in my opinion, is an eclectic procedure. From the standpoint of sound accounting theory, all losses—realized or anticipated—should be recognized as deductions from income, while realized gains should be additions to income. Unrealized gains should be kept in a reserve until they actually become realized. This is in accord with the practices outlined by Eastman Kodak, General Motors, Goodrich and Goodyear. In addition, I suggest creating a reserve which can be used as a shock absorber for unusual losses.

Objection may be raised to the use of this procedure on the ground that it is impossible to segregate realized from unrealized items. The criticism is valid when the books of the foreign branch or subsidiary are kept only in terms of the foreign currency. If the records are maintained in both currencies, realized may be
segregated from unrealized amounts. While it would be desirable
to keep accounts in two currencies, it must be admitted that it is a
very costly practice. In most cases the results obtained by ordi-
nary accounting methods—especially where average rates of a
period are used for the conversion of the profit-and-loss account—
are accurate enough over a period to warrant approximate dis-
tinctions between realized and unrealized gains and losses on
foreign exchange. Where current conditions are such that it is
impracticable or impossible to separate realized from unrealized
items with any degree of accuracy, the most desirable treatment
seems to be the sequestration of gains—against which losses may
be charged—in a reserve until international stabilization of foreign
exchanges shall have been effected.

Even where accounts are maintained only in the foreign cur-
rency, it is possible to determine some profits which are actually
realized. Whenever a current asset is definitely segregated, such
as a bank balance, any change in the foreign-exchange quotation
which results in a profit at the time of remittance may be said to
have accrued to the isolated item. In the same way, any part of
inventory may be ear-marked as it passes from producer to cus-
tomer, and unrealized exchange gains may be determined at each
stage of the process. These gains could be classed as realized
only when United States currency is received in payment for
them. A compensatory practice might be the maintaining of
records in both currencies for the larger accounts of a business,
thereby determining the realized profits for part of a period’s
transactions. It would give some indication of the percentage of
gain or loss ordinarily experienced which was due to fluctuations
of the exchange rates.

If American concerns desire the segregation of all ordinary
operating incomes and losses from foreign-exchange variations,
they should initiate the custom of keeping their records both in
the foreign currency and in dollars—at least as long as there is
danger of extraordinary fluctuations in the foreign currency.
By this is meant the removal of all amounts of additional gross
income or loss so far as it is possible. It would be necessary to
determine the effect of foreign-exchange movements upon prices
received for goods at the time the wares were sold. Again, it
would be necessary to determine the accrual of gain or loss from
exchange when the receivable was liquidated by payment in a
foreign currency. Fluctuations in exchange would also have to
be accounted for when the foreign currency was converted into American money.

However, practical difficulties loom before the adoption of this suggestion in practice. As an alternative I suggest, where records are maintained only in the foreign currency, the following procedures for consideration:

1. Convert profit-and-loss accounts at average rates for the period selected.
2. Recognize capital losses upon devaluation.
3. In recording profits and losses on remittances and conversions:
   A. Carry all realized and anticipated losses to profit-and-loss.
   B. Close all realized gains to the income account.
   C. Credit all unrealized gains to a reserve, removing therefrom to profit-and-loss as they are realized.
   D. Set up a reserve for contingencies to serve as a shock absorber for any extraordinary items.

Notes:
1. There is the possibility, of course, that nations may decide to manage a stable internal price level, and allow the exchanges to vary in perpetuity. I have not taken this eventuality into consideration in the preparation of this paper.
2. The exception of the Goodyear Company, which converts preferred stock and funded debt in the hands of the public at current rates, has been noted. The reader may attempt to determine the implications of this practice himself.
3. An example will serve to clarify the points on conversion of profit-and-loss accounts, an intricate subject at best. The example consists of a series of balance-sheets of a foreign branch, with appropriate remarks on cogent points. In actual operation the time sequence will probably be altered, but the argument will remain substantially the same. I have chosen to select the remittance of profits as the basis for the argument, but the reader may obtain the same conclusions by assuming that the remittances made are on intercompany account.

<table>
<thead>
<tr>
<th>I</th>
<th>Statement at the beginning of the period</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td><strong>£</strong></td>
</tr>
<tr>
<td>Misc.</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>II</strong></td>
<td>Showing profits earned in period</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td><strong>£</strong></td>
</tr>
<tr>
<td>Misc.</td>
<td>60,000</td>
</tr>
<tr>
<td>Profits</td>
<td></td>
</tr>
<tr>
<td>Profits</td>
<td></td>
</tr>
<tr>
<td><strong>III</strong></td>
<td>£30,000 profits are remitted when rate is £4.90</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td><strong>£</strong></td>
</tr>
<tr>
<td>Misc.</td>
<td>30,000</td>
</tr>
<tr>
<td>Loss on exchange</td>
<td>612</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>30,612</td>
</tr>
</tbody>
</table>
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IV
Statement II converted when the market rate is $5, at the average rate at which profits were earned

\[
\begin{array}{l|c|c}
\text{Assets} & \$ & \text{Liabilities} \\
\hline
\text{Misc.} & 300,000 & \text{Inter co. acct.} \\
\text{Profits} & 140,000 & \\
\text{Unrealized gain on conversion} & 10,000 & (arising from converting £10,000 gained at a rate of $4 at $5 to the £)
\end{array}
\]

\[=\]

\[
\begin{array}{l|c|c}
\text{Assets} & \$ & \text{Liabilities} \\
\hline
\text{Misc.} & 300,000 & \text{Inter co. acct.} \\
\end{array}
\]

V
Statement III converted at market rate of $4.90

\[
\begin{array}{l|c|c}
\text{Assets} & \$ & \text{Liabilities} \\
\hline
\text{Assets} & 147,000 & \text{Liabilities} \\
\text{Misc.} & 147,000 & \text{Inter co. acct.} \\
\text{Loss on exchange} & 3,000 & \\
\end{array}
\]

\[=\]

\[
\begin{array}{l|c|c}
\text{Assets} & \$ & \text{Liabilities} \\
\hline
\text{Misc.} & 150,000 & \text{Inter co. acct.} \\
\end{array}
\]

VI
Statement II converted when the market rate is $5, at the rate at which remittance was made

\[
\begin{array}{l|c|c}
\text{Assets} & \$ & \text{Liabilities} \\
\hline
\text{Misc.} & 300,000 & \text{Inter co. acct.} \\
\text{Profits} & 147,000 & \\
\text{Unrealized gain on conversion} & 3,000 & (£10,000 arising from converting £10,000 gained at a rate of $4 at $5, less $7,000 unrealized profit included as operating profit)
\end{array}
\]

\[=\]

\[
\begin{array}{l|c|c}
\text{Assets} & \$ & \text{Liabilities} \\
\hline
\text{Misc.} & 300,000 & \text{Inter co. acct.} \\
\end{array}
\]

VII
Statement III converted at market rate of $4.90—same as V above

Remarks: The ultimate results are the same in both instances, $147,000 profit. When remittance rates are used for conversion, and they are higher than the rates current when the assets were earned, it results in inflating operating profits by the amount of final gain on exchange.

The preceding example used a weighted average rate for the conversion of the profit-and-loss account. If a simple, arithmetical average is used, unless the figure fortuitously happens to be the same as the weighted average, an indeterminate amount of unrealized loss or gain on exchange will be "buried" in the converted profit-and-loss account.

4. See last paragraph of note 3.

5. Note J to schedule VI, form 8, states, "Net profits or losses resulting from such conversions of foreign currency into United States dollars are credited or charged to a reserve for foreign-exchange fluctuations, or suspended as 'unadjusted debits'."

6. The Standard Oil Co. had a reserve for foreign-exchange fluctuations of $26,130,701.01 at December 31, 1934.

7. While, for reasons stated elsewhere in this paper, I do not relish the practice of closing exchange items to surplus as a regular occurrence, I can see no great objection to carrying extraordinary losses—such as those incurred by the devaluation of a country's currency—to the surplus account.

8. Westinghouse introduces a note of conservatism in the practice of closing exchange items to surplus; the company charges losses to surplus and credits gains to a reserve.

9. The basis for including the Borden Company in this classification should be explained: In 1931 a reserve for net current assets in foreign countries was created from surplus. "At the end of 1933 the adjustment made in 1931 . . . was reversed. . . . The circumstances which necessitated the creation of this reserve did not exist at the close of 1933."

10. While the consolidated balance-sheet records a reserve "for future fluctuations in investments and foreign exchange" of $2,200,000, there is a credit of "other income" in the consolidated income account of "interest earned, income from investments, foreign-exchange adjustments, etc." amount-
ing to $673,301.91. It is questionable, from the evidence given, whether or not this should be classed strictly as one following a "reserve policy".

11. Fox Film set up a "reserve for fluctuation in dollar value of working assets in foreign countries in the amount of $250,000.00" from the profits on foreign exchange (amounting to $669,560.81 for 39 weeks in 1933) at December 30, 1933. This reserve still appeared on the books as of the end of 1934.

12. National Cash Register Company set up a reserve for exchange losses of $430,836.43 from 1933 profits. This was cleared by losses in 1934. In addition, $333,251.08 was charged to income.
The Plant Ledger for a Small Manufacturer

BY JOHN H. GOODWIN

That many small manufacturing plants have inadequate records of investment in fixed assets is an unfortunate fact and one which must be due only to a failure to realize the importance of keeping such records. Careful and detailed records of the other assets are commonly kept, but that asset which usually represents a large proportion of the invested capital of the company is lumped together in a few major accounts, viz.: land, buildings, machinery and equipment, office equipment.

In the belief that the subject of a plant ledger for a small manufacturing establishment may be of interest, the procedure in installing such a system of fixed-assets accounting in an actual case will be described.

The basic reason for the installation of a plant ledger in the case to be discussed was the necessity for supplying certain information required by the federal income-tax laws and regulations, more specifically that information required by IT: A & C mimeograph coll. No. 4170, R.A. No. 714, which states the procedure to be followed in carrying out the provisions of treasury decision 4422.

The corporation is a small manufacturing plant which makes, for the most part, a uniform product in volume production. It has an invested capital of approximately $175,000. Its sales normally run from $300,000 to $400,000 a year. The annual payroll for 130 employees is about $135,000, excluding salaries of officers. It has an investment in fixed assets, after depreciation, of approximately $100,000. These fixed assets, after installation of the plant ledger, were represented by 375 cards.

The installation of the plant ledger was based upon the following sources of information in addition to the books themselves:

1. Analyses of fixed-asset accounts prepared previously in the course of regular audits.
2. Reports on previous years by examining officers of the United States treasury department.
3. An appraisal made a few years prior to the installation.
4. A floor plan of the plant divided into departments which had been prepared a short time before in the installation of a cost system.
The analyses of the fixed assets were completed in detail to the end of the last preceding year. By these analyses all additions to fixed-assets accounts were allocated to specific items—if additions to buildings, to a particular building or section of the building; or, if they were machines or office equipment, to a specific machine or item of office equipment. It was possible to do this by reference to invoices, by questioning officers and employees, and by search of the minutes of the corporation. There was a comparatively small amount, representing additions to machinery in the earliest, as yet not fully depreciated, years, which could not be so specifically allocated. These amounts were classified in lump sums by the years in which the additions were made.

After completion of the analyses of the various fixed-asset accounts they were summarized according to the years in which the additions were made to show cost and accumulated depreciation to the end of the last preceding year. The summary schedules so prepared were then compared with similar schedules prepared by the United States treasury department examining officer in the last examination of the taxpayer's books. The causes of any discrepancies were investigated and the schedules were corrected where necessary.

The next step was the preparation of a work sheet for the accumulation of the information necessary in transferring the data to individual plant-ledger sheets. In the case of the "buildings" account, separation was made only into the several buildings or sections of buildings according to purpose, type of construction, date of construction and expected life. "Machinery and equipment" and "office equipment," however, were broken down into specific items and a sheet was used for each machine or piece of equipment.

The work sheets were drawn up to show name of item, from whom purchased, date purchased, cost, reserve for depreciation to the end of the last year closed with the treasury department, which was the year ended December 31, 1932, and estimated remaining life from that date.

The form was as follows:

<table>
<thead>
<tr>
<th>Items</th>
<th>Date purchased</th>
<th>Cost</th>
<th>Reserve for depreciation 12-31-32</th>
<th>Estimated remaining life</th>
</tr>
</thead>
<tbody>
<tr>
<td>XY Machine No. etc.</td>
<td>3-26-24</td>
<td>$500</td>
<td>$300</td>
<td>5 years</td>
</tr>
</tbody>
</table>
The Journal of Accountancy

The figures to be accumulated on these work sheets were taken from the completed analyses of the fixed-asset accounts mentioned above. The amount of each charge made to the fixed asset account was entered under the name of the individual machine or piece of equipment. In some cases there was only one amount under a machine. In most cases, however, there were several amounts making up to the total cost—-as, cost of machine itself, freight, cost of setting up, etc.

After the cost of all assets had been thus transferred to the work sheets, the reserve for depreciation was computed for each machine or piece of equipment and entered in the reserve-for-depreciation column. This computation was made by reference to rates of depreciation previously taken.

At this point all the information had been accumulated and properly classified, except the estimate of the remaining life of each item. Before making this estimate, the figures were proved by totalling all figures for cost and for reserve for depreciation as shown on the work sheets by years in which purchased and comparing these totals with the figures contained in the summary schedules previously made, as mentioned above, showing fixed assets as to cost and reserve for depreciation by years in which the additions were made.

The work sheets were then taken into the plant and an attempt was made to get as accurate an estimate of the remaining useful life as possible by talking with those employees who were most familiar with each machine or other piece of equipment. After tentative estimates of the remaining life of each machine had been made in this way, the entire list was discussed, item by item, with the general manager of the plant, and corrections in the original estimates were made where they were considered necessary.

Now the figures were ready to be entered on plant-ledger sheets—a sheet for each machine or piece of equipment.

These sheets are 4½ inches x 10½ inches, punched along the left-hand edge to be filed in a sturdy binder. The name of the item appears on the bottom of the sheet, so that in filing, each sheet is filed slightly higher on the page than the preceding sheet, thus giving a visible file. The sheets are ruled to show date purchased, voucher number, from whom purchased, explanation (original cost, freight, installation charges, etc.), cost and depreciation—by years and accumulated total. (See form A.)
After the data had been transferred to the plant-ledger sheets these sheets were arranged according to the departments in which each machine or piece of equipment was located. This allocation by departments was verified by reference to the appraisal report on hand and by actual inspection in the plant. The sheets were then grouped in each department according to estimated remaining life.

Where it was found that machines or equipment were on hand, although there were no cards indicating the existence of such items, investigation was made, if the items were large enough to be of consequence, of the reason for the absence of such a record. The first step was to find by inquiry the approximate date of acquisition. Search was then made of the accounting records to see whether their failure to appear therein was due to the fact that the items in question had not been capitalized or had been fully depreciated and removed from the books.

If the item had not been capitalized, it was entered on a plant-ledger sheet, depreciation was accrued in accordance with estimated life as indicated by its present condition, and an entry was made on the general books to reveal the capitalization of the item and accrual of depreciation. If, on the other hand, it had been capitalized and subsequently written off as fully depreciated, it was entered on a plant-ledger sheet with cost and depreciation in equal amounts, filed as such with the sheets in its department and recorded in the general ledger accounts.

Where plant-ledger sheets were on hand for which there were no machines or pieces of equipment in existence, it was obvious that
assets had been discarded or sold but had not been removed from the books. In those cases the sheets were destroyed and the items as to cost and accrued depreciation were removed from the accounts in the general ledger.

Working from the plant ledger, each machine or piece of equipment was given a number, which appeared on its plant-ledger sheet. These numbers were then marked on the physical item itself, either by attachment of a numbered tag or by stenciled number.

The plant ledger was then complete and ready for operation.

The plant ledger is operated, and in all cases should be operated, by an employee who thoroughly understands the theory behind the practice. It is not work for an irresponsible, incompetent clerk who does not understand what he or she is doing. This observation is made because quite often, after a plant ledger has been installed, its operation is left to an employee as a spare-time job. The work is neglected, the ledger gets out of balance and it very easily becomes unmanageable and useless.

In proper operation of a plant ledger the sheets are filed, as mentioned before, by departments, subdivided according to estimated life, in a sturdy binder in a visible index form. The employee, in the present case, examines all invoices for account classification and keeps a running analysis of each year's capital addition. Periodically during the year new sheets are prepared and inserted in the binder for machines or equipment purchased.

At the end of each year, depreciation is computed on the basis of estimated remaining life and is entered on the sheets. When a sheet shows that an item is fully depreciated its treatment depends on whether or not the machine or equipment is in use. If not, then it is actually fully depreciated. The sheet is then removed from the plant ledger and the amount of the cost and the accrued depreciation are eliminated from the accounts in the general ledger. If, however, the item is still in use, the sheet is grouped with similar items in its department, as fully depreciated though still in use, and no elimination is made from the accounts in the general books.

With its plant ledger installed and in operation the corporation now has a complete, detailed inventory of its fixed assets.

An appraisal of its fixed assets, if desired, can be made more quickly, more accurately, and more economically.
In computing insurance coverage or proving a loss the company has specific records from which to work.

For purposes of establishing its depreciation deduction for federal income-tax purposes the company has complete, detailed and sound supporting data which can be easily summarized for presentation.

Should it be necessary to establish the investment in fixed assets, a complete, accurate record is at hand for that purpose.
Students' Department

H. P. BAUMANN, Editor

AMERICAN INSTITUTE EXAMINATIONS

[Note.—The fact that these answers appear in The Journal of Accountancy should not cause the reader to assume that they are the official answers of the board of examiners. They represent merely the opinions of the editor of the Students' Department.]

Examination in Accounting Theory and Practice—Part I

November 14, 1935, 1:30 P. M. to 6:30 P. M.

Solve problem 1 or 2, problems 3, 4 and 5 and problem 6 or 7.

No. 3 (25 points):

The capital of the co-partnership of Goe & Gettem amounted to $40,000, of which Goe contributed $25,000 and Gettem $15,000. The arrangement with respect to the distribution of profits was that Goe received 60% and Gettem 40%. The capital contributions referred to represented the amount of the capital of the respective partners immediately prior to the admission of Goode as a partner on January 1, 1933.

By agreement among the three partners the aggregate contributed capital of the new firm at its inception on January 1, 1933, was to continue at $40,000, Goode to pay to Goe, personally, $10,000 for the transfer from Goe's capital account to Goode's capital account of a one-quarter interest and Goode to have a 20% interest in the profits or losses, thus making the interests in profits and losses of Goode and Gettem 40% each.

The profits for 1933 amounted to $15,000 and during the year Goode withdrew $7,000, Gettem $5,000 and Goode $2,500. A loss of $25,000 was sustained in 1934 and the withdrawals during that year were: Goode $4,000, Gettem $3,000, Goode $2,000. Goode had advanced $1,000 as a loan and the other liabilities at December 31, 1934, consisted of trade accounts payable.

When it was decided at the end of 1934 to liquidate, the trade creditors were paid in full from the cash on hand and the collections of accounts receivable. Of the then remaining $7,500 assets $6,500 were sold for $1,500 cash. It was agreed that this cash should be distributed before realization of the sole remaining asset of $1,000, the value of which was problematical. Assuming that Goode and Gettem may have to absorb any deficiency on Goode's accounts—

1. How should the $1,500 cash be distributed?
2. How should the proceeds from the sale of the doubtful asset be distributed if $800 is ultimately realized?
3. How if $5,000 is ultimately realized?
4. What is the amount that should be realized so that Goode's share may exactly reimburse his partners for the deficiency assumed by them?
### Solution:

**Goe, Gettem and Goode**

Statement of partners' capital accounts for the period from January 1, 1933, to December 31, 1934

<table>
<thead>
<tr>
<th>Capital accounts</th>
<th>Goe (40%)</th>
<th>Gettem (40%)</th>
<th>Goode (20%)</th>
<th>Goode loan account</th>
<th>Together</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balances, January 1, 1933</td>
<td>$25,000.00</td>
<td>$15,000.00</td>
<td>$6,250.00</td>
<td></td>
<td>$40,000.00</td>
</tr>
<tr>
<td>Transferred from Goe to Goode</td>
<td></td>
<td></td>
<td></td>
<td>6,250.00</td>
<td></td>
</tr>
<tr>
<td>Balances after admission of Goode</td>
<td>$18,750.00</td>
<td>$15,000.00</td>
<td>$6,250.00</td>
<td></td>
<td>$40,000.00</td>
</tr>
<tr>
<td>Add:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profits for 1933</td>
<td>$6,000.00</td>
<td>$6,000.00</td>
<td>$3,000.00</td>
<td></td>
<td>$15,000.00</td>
</tr>
<tr>
<td>Total</td>
<td>$24,750.00</td>
<td>$21,000.00</td>
<td>$9,250.00</td>
<td></td>
<td>$55,000.00</td>
</tr>
<tr>
<td>Deduct:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Withdrawals</td>
<td>$7,000.00</td>
<td>$5,000.00</td>
<td>$2,500.00</td>
<td></td>
<td>$14,500.00</td>
</tr>
<tr>
<td>Balances, December 31, 1933</td>
<td>$17,750.00</td>
<td>$16,000.00</td>
<td>$6,750.00</td>
<td></td>
<td>$40,500.00</td>
</tr>
<tr>
<td>Deduct:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss for 1934</td>
<td>$10,000.00</td>
<td>$10,000.00</td>
<td>$5,000.00</td>
<td></td>
<td>$25,000.00</td>
</tr>
<tr>
<td>Goe 40%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gettem 40%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goode 20%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total deductions</td>
<td>$14,000.00</td>
<td>$13,000.00</td>
<td>$7,000.00</td>
<td></td>
<td>$34,000.00</td>
</tr>
<tr>
<td>Balances before loan</td>
<td>$3,750.00</td>
<td>$3,000.00</td>
<td>$250.00</td>
<td></td>
<td>$6,500.00</td>
</tr>
<tr>
<td>Add:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balances, December 31, 1934 (before liquidation)</td>
<td>$3,750.00</td>
<td>$3,000.00</td>
<td>$250.00</td>
<td>$1,000.00</td>
<td>$7,500.00</td>
</tr>
<tr>
<td>Deduct: loss:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets sold</td>
<td>$6,500.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash received</td>
<td>1,500.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss</td>
<td>$5,000.00</td>
<td>2,000.00</td>
<td>2,000.00</td>
<td>1,000.00</td>
<td>5,000.00</td>
</tr>
<tr>
<td>Balances, December 31, 1934 (after loss)</td>
<td>$1,750.00</td>
<td>$1,000.00</td>
<td>$1,250.00</td>
<td>$1,000.00</td>
<td>$2,500.00</td>
</tr>
</tbody>
</table>

Note: The problem states that Goode was to pay to Goe, personally, "$10,000 for the transfer from Goe's capital account to Goode's capital account, a one-quarter interest." A one-quarter interest in the total capital of the partnership investment, or a one-quarter interest in Goe's investment in the partnership? If it was intended to transfer a one-quarter interest in the total investment of $40,000, or $10,000 to Goode's capital account, Goode would have a credit balance of $2,500, and Goe a debit balance of $2,000 at June 31, 1934, after providing for the loss of $5,000 on the sale of the assets. However, this does not seem to be the intention of the examiners for the problem states "that Goe and Gettem may have to absorb any deficiency on Goode's accounts." This solution is based upon a transfer of one-quarter of the balance in Goe's account to Goode.
### (1) Statement showing the distribution of the $1,500 cash.

<table>
<thead>
<tr>
<th>Profit-and-loss ratio</th>
<th>Capital accounts</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Balances, December 31, 1934 (after loss)</td>
<td>Goede (40%)</td>
<td>Gettem (40%)</td>
</tr>
<tr>
<td>Additional possible loss:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset unrealized</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goe (40%)</td>
<td>400.00</td>
<td>400.00</td>
</tr>
<tr>
<td>Gettem (40%)</td>
<td>400.00</td>
<td></td>
</tr>
<tr>
<td>Goode (20%)</td>
<td></td>
<td>400.00</td>
</tr>
<tr>
<td>Balances</td>
<td>$1,350.00</td>
<td>$600.00</td>
</tr>
<tr>
<td>Transfer Goode's loan account to capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balances, after transfer</td>
<td>$1,350.00</td>
<td>$600.00</td>
</tr>
<tr>
<td>Additional possible loss:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On Goode's account</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goe (40/80)</td>
<td>225.00</td>
<td></td>
</tr>
<tr>
<td>Gettem (40/80)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balances, after transfer</td>
<td>$1,125.00</td>
<td>$375.00</td>
</tr>
</tbody>
</table>

### (2) Statement showing the distribution of the proceeds from the sale of the doubtful asset which was sold for $800.

<table>
<thead>
<tr>
<th>Profit-and-loss ratio</th>
<th>Capital accounts</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Balances, December 31, 1934 (after loss)</td>
<td>Goede (40%)</td>
<td>Gettem (40%)</td>
</tr>
<tr>
<td>First cash distribution</td>
<td>$1,750.00</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>Balances, after first cash distribution</td>
<td>$1,125.00</td>
<td>$375.00</td>
</tr>
<tr>
<td>Additional loss on sale of asset:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>$1,000.00</td>
<td></td>
</tr>
<tr>
<td>Amount received</td>
<td>800.00</td>
<td></td>
</tr>
<tr>
<td>Loss</td>
<td>$200.00</td>
<td></td>
</tr>
<tr>
<td>Goe (40%)</td>
<td>80.00</td>
<td></td>
</tr>
<tr>
<td>Gettem (40%)</td>
<td></td>
<td>80.00</td>
</tr>
<tr>
<td>Goode (20%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balances</td>
<td>$545.00</td>
<td>$545.00</td>
</tr>
<tr>
<td>Transfer Goode's loan account to capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balances, after transfer</td>
<td>$545.00</td>
<td>$545.00</td>
</tr>
<tr>
<td>Additional possible loss on Goode's account</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goe (40/80)</td>
<td>145.00</td>
<td></td>
</tr>
<tr>
<td>Gettem (40/80)</td>
<td></td>
<td>145.00</td>
</tr>
<tr>
<td>Cash to be distributed</td>
<td>$400.00</td>
<td>$400.00</td>
</tr>
</tbody>
</table>
(3) Statement showing the distribution of $5,000 cash received on the realization of the "sole remaining asset."

**Note.**—As it was agreed that the $1,500 cash should be distributed before realization of the sole remaining asset of $1,000, it is understood that $5,000 was received for this asset. The following statement begins with the balances in the accounts after the payment of the $1,500 as shown in (2).

<table>
<thead>
<tr>
<th>Capital accounts</th>
<th>Goode (40%)</th>
<th>Gettem (40%)</th>
<th>Goode (20%)</th>
<th>Goode loan account</th>
<th>Together</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balances, December 31, 1934, after the first cash distribution of $1,500</td>
<td>$625.00</td>
<td>$625.00</td>
<td>$1,250.00</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>Profit and loss ratio</td>
<td>$4,000.00</td>
<td>$4,000.00</td>
<td>$800.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit on sale of sole remaining asset:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selling price</td>
<td>$5,000.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>$1,000.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit</td>
<td>$4,000.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goode (40%)</td>
<td>1,600.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gettem (40%)</td>
<td>1,600.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goode (20%)</td>
<td>800.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transfers and debit balance in Goode's capital account to his loan account:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balances</td>
<td>$2,225.00</td>
<td>$2,225.00</td>
<td>$450.00</td>
<td>$1,000.00</td>
<td>$5,000.00</td>
</tr>
<tr>
<td>Cash to be distributed</td>
<td>$2,225.00</td>
<td>$2,225.00</td>
<td>$450.00</td>
<td>$550.00</td>
<td>$5,000.00</td>
</tr>
</tbody>
</table>

(4) Statement showing the amount that should be realized so that Goode's share may exactly reimburse his partners for the deficiency assumed by them.

**Note.**—The balance in Goode's account at December 31, 1934 ($1,250), after offsetting his credit in the loan account ($1,000) is a $250 debit balance. As his share of the profits is 20%, any profit which exactly equals five times that debit balance would eliminate the deficiency, as shown below:

<table>
<thead>
<tr>
<th>Capital accounts</th>
<th>Goode (40%)</th>
<th>Gettem (40%)</th>
<th>Goode (20%)</th>
<th>Goode loan account</th>
<th>Together</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balances, December 31, 1934, after the first cash distribution of $1,500</td>
<td>$625.00</td>
<td>$625.00</td>
<td>$1,250.00</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>Profit and loss ratio</td>
<td>$1,250.00</td>
<td>$1,250.00</td>
<td>$250.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit on sale of sole remaining asset:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selling price</td>
<td>$2,250.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>$1,000.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit</td>
<td>$1,250.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goode (40%)</td>
<td>500.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gettem (40%)</td>
<td>500.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goode (20%)</td>
<td>250.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transfers and debit balance in Goode's capital account to his loan account:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balances</td>
<td>$1,125.00</td>
<td>$1,125.00</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
<td>$2,250.00</td>
</tr>
<tr>
<td>Cash to be distributed</td>
<td>$1,125.00</td>
<td>$1,125.00</td>
<td>$1,000.00</td>
<td>$2,250.00</td>
<td></td>
</tr>
</tbody>
</table>
No. 4 (20 points):

The Roane Realty Company purchased a sixty-acre tract of land (43,560 square feet to an acre) for $24,000 and spent $91,620 for improvements and expenses. Of the acreage 701,100 square feet were used for streets, parkways, alleys, etc.

No sales were made during the first year. During the second year lots were placed on the market and sales were made based on two classes. One-third of the land was placed in a class called "A" and the balance was classed as "B." The lots were of equal size and contained 12,750 square feet each. The price was 8¢ per square foot for class A and 7¢ per square foot for class B lots, with discount of 10% on all sales for cash.

In the second year 10 class A and 17 class B lots were sold. Four of the ten sales of class A, and six of the seventeen sales of class B were for cash. The other sales were on the basis of 10% cash and nine additional equal payments.

During the third year all the other lots were sold. Ten class A and twenty-five class B lots were sold for cash; the rest on the ten-payment plan.

Profit is to be considered as earned and unearned. Earned profit is that part of the profit that is realized by actual collection. At the end of the second year (the first year of sales) there was still due on instalment sales an average of four instalments which were paid in the third year. At the end of the third year there was an average balance on instalment sales of three payments, all good and collectible.

State the earned profit for each of the two years in which sales were made. Carrying charges need not be considered.

Solution:

The total number of square feet in the 60 acre tract is (43,560 square feet times 60) ............ 2,613,600 square feet
from which the amount used for streets, parkways, tract alleys, etc., should be deducted .... 701,100

leaving the amount applicable to salable lots of ... 1,912,500 square feet

As there are 12,750 square feet to each lot, the number of lots available for sale is determined to be (1,912,500 ÷ 12,750) 150. These lots are further divided between class "A" and class "B" in the ratio of 1 to 2 so that we find that there were:

<table>
<thead>
<tr>
<th>Class</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;A&quot;</td>
<td>50</td>
</tr>
<tr>
<td>&quot;B&quot;</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td>150</td>
</tr>
</tbody>
</table>

The selling price of these lots by classes was:

<table>
<thead>
<tr>
<th>Class</th>
<th>Each</th>
<th>Number</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;A&quot;</td>
<td>$1,020.00</td>
<td>50</td>
<td>$51,000.00</td>
</tr>
<tr>
<td>(12,750 times 8¢)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&quot;B&quot;</td>
<td>892.50</td>
<td>100</td>
<td>89,250.00</td>
</tr>
<tr>
<td>(12,750 times 7¢)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td>150</td>
<td>$140,250.00</td>
</tr>
</tbody>
</table>

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The cost of these lots by classes was:

**Total cost:**

- Land ........................................... $24,000.00
- Improvements and expenses .................. 91,620.00

**Total** ........................................... $115,620.00

Allocated to the two classes of lots, as follows:

<table>
<thead>
<tr>
<th>Class</th>
<th>Total</th>
<th>Each</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class &quot;A&quot;</td>
<td>(51,000/140,250 times $115,620.00)</td>
<td>$42,043.64</td>
</tr>
<tr>
<td>Class &quot;B&quot;</td>
<td>(89,250/140,250 times $115,620.00)</td>
<td>73,576.36</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>$115,620.00</td>
</tr>
</tbody>
</table>

The gross profit on these lots by classes was:

<table>
<thead>
<tr>
<th>Class</th>
<th>Class</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;A&quot;</td>
<td>&quot;B&quot;</td>
</tr>
<tr>
<td>Sales price</td>
<td>$1,020.00</td>
</tr>
<tr>
<td>Cost</td>
<td>840.87</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$179.13</td>
</tr>
</tbody>
</table>

The unearned "income" is computed by ascertaining the gross profit on the number of lots sold and by multiplying that result by the percentage of uncollected instalments.

**The unearned income (gross profit) by years:**

- **Second year**
  - Percentage of uncollected instalments ....................... 40%
  - Class "A":
    - Lots sold on instalment plan ................................ 6
    - Unearned income ............................................. $429.91
  - Class "B":
    - Lots sold on instalment plan ................................ 11
    - Unearned income ............................................. $689.66

- **Third year**
  - Percentage of uncollected instalments ....................... 30%
  - Class "A":
    - Lots sold on instalment plan ................................ 30
    - Unearned income ............................................. $1,612.17
  - Class "B":
    - Lots sold on instalment plan ................................ 58
    - Unearned income ............................................. $2,727.28
### The Journal of Accountancy

**The Roane Realty Company**

Statement of gross income, by classes of lots, for the second year

<table>
<thead>
<tr>
<th>Number of lots sold</th>
<th>Class “A” (10)</th>
<th>Class “B” (17)</th>
<th>Total (27)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross sales:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash sales</td>
<td>$ 4,080.00</td>
<td>$ 5,355.00</td>
<td>$ 9,435.00</td>
</tr>
<tr>
<td>Instalment sales</td>
<td>6,120.00</td>
<td>9,817.50</td>
<td>15,937.50</td>
</tr>
<tr>
<td><strong>Total sales</strong></td>
<td><strong>$10,200.00</strong></td>
<td><strong>$15,172.50</strong></td>
<td><strong>$25,372.50</strong></td>
</tr>
<tr>
<td>Less: discount on cash sales (10%)</td>
<td>408.00</td>
<td>535.50</td>
<td>943.50</td>
</tr>
<tr>
<td><strong>Net sales</strong></td>
<td><strong>$ 9,792.00</strong></td>
<td><strong>$14,637.00</strong></td>
<td><strong>$24,429.00</strong></td>
</tr>
</tbody>
</table>

**Deduct:** cost of sales:

- Class “A” (10 lots at $840.87)........ 8,408.70
- Class “B” (17 lots at $735.76)........ 12,507.92

**Gross profit on sales**............. $1,383.30 $2,129.08 $3,512.38

**Deduct:** unearned income (gross profit)............. 429.91 689.66 1,119.57

**Gross profit earned**............. $ 953.39 $ 1,439.42 $2,392.81

---

### The Roane Realty Company

Statement of gross income, by classes of lots, for the third year

<table>
<thead>
<tr>
<th>Number of lots sold</th>
<th>Class “A” (40)</th>
<th>Class “B” (83)</th>
<th>Total (123)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross sales:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash sales</td>
<td>$10,200.00</td>
<td>$22,312.50</td>
<td>$32,512.50</td>
</tr>
<tr>
<td>Instalment sales</td>
<td>30,600.00</td>
<td>51,765.00</td>
<td>82,365.00</td>
</tr>
<tr>
<td><strong>Total sales</strong></td>
<td><strong>$40,800.00</strong></td>
<td><strong>$74,077.50</strong></td>
<td><strong>$114,877.50</strong></td>
</tr>
<tr>
<td>Less: discount on cash sales (10%)</td>
<td>1,020.00</td>
<td>2,231.25</td>
<td>3,251.25</td>
</tr>
<tr>
<td><strong>Net sales</strong></td>
<td><strong>$39,780.00</strong></td>
<td><strong>$71,846.25</strong></td>
<td><strong>$111,626.25</strong></td>
</tr>
</tbody>
</table>

**Deduct:** cost of sales:

- Class “A” (40 lots at $840.87)........ 33,634.80
- Class “B” (83 lots at $735.76)........ 61,068.08

**Gross profit on sales**............. $ 6,145.20 $10,778.17 $16,923.37

**Deduct:** unearned income (gross profit)............. 1,612.17 2,727.28 4,339.45

**Gross profit earned on sales of third year**............. $ 4,533.03 $ 8,050.89 $12,583.92

**Add:** gross profit earned on second years’ sales............. 429.91 689.66 1,119.57

**Gross profit earned for the year**............. $ 4,962.94 $ 8,740.55 $13,703.49

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Students' Department

No. 5 (15 points):

John Gibbon died January 1, 1930, and left his property in trust to his daughter Ethel. The income was to be paid to her as long as she lived and at her death the trust was to go to his nephew, William Gibbon. He appointed John Doe trustee at a fixed fee of $5,000 per annum. All expenses of settling the estate were paid and accounted for by the executor before the trustee took it over.

Ethel died on September 30, 1933, and left all her property in trust to her cousin, Joseph Hart. John Doe was appointed executor and trustee of her estate and he agreed not to make any additional charges for these services. All income was to be paid to Joseph Hart. The estate, which consisted solely of Ethel's unexpended income from the John Gibbon trust, was immediately invested in 4% certificates of deposit.

The property received under the will of John Gibbon on January 1, 1930, was:
10,000 shares of the K. O. Corporation, valued at $100 each.
$300,000 bonds of the K. O. Corporation, paying interest on June 30th and December 31st at 6% per annum.

In the five years ended December 31, 1934, the trustee received the following dividends on the stock:

<table>
<thead>
<tr>
<th>Date</th>
<th>Dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td>February 1, 1930</td>
<td>$40,000</td>
</tr>
<tr>
<td>&quot; &quot; 1931</td>
<td>40,000</td>
</tr>
<tr>
<td>&quot; &quot; 1932</td>
<td>40,000</td>
</tr>
<tr>
<td>&quot; &quot; 1933</td>
<td>60,000</td>
</tr>
<tr>
<td>&quot; &quot; 1934</td>
<td>60,000</td>
</tr>
</tbody>
</table>

and he made the following payments:

Expenses:
$100 a month, totaling $6,000
To beneficiaries:

Ethel Gibbon
1930 $27,250
1931 35,000
1932 25,000
1933 37,000  $124,250

William Gibbon
1933 $17,000
1934 46,000  $63,000

Joseph Hart
1934 $3,000

The surplus income was left on deposit in the bank and drew no interest. Prepare trustee's accounts covering the five years ended December 31, 1934, showing the beneficiaries' interests.

Solution:

John Gibbon Trust—John Doe, Trustee

Charge and discharge statement as to principal from January 1, 1930, to December 31, 1934

I charge myself with:

Assets per inventory:
10,000 shares of the K. O. Corporation valued at $100 each $1,000,000.00
$300,000 par value of bonds of the K. O. Corporation paying interest at 6% per annum on June 30th and December 31st. 300,000.00
Total $1,300,000.00

The above assets belonging to the trust are still in the trustee's possession at December 31, 1934.
JOHN GIBBON TRUST—JOHN DOE, TRUSTEE

Charge and discharge statement as to income from January 1, 1930, to December 31, 1934

I charge myself with:

Dividends on 10,000 shares of K. O. Corporation stock... $ 240,000.00
Interest on K. O. 6% bonds................................. 90,000.00

Total.......................................................... $ 330,000.00

I credit myself with:

Expenses:
Expenses......................................................... $ 6,000.00
Trustee’s fees................................................. 25,000.00 $ 31,000.00

Payments to beneficiaries:
Ethel Gibbon................................................. $124,250.00
William Gibbon.............................................. 63,000.00 187,250.00

Payment to the executor of the estate of Ethel Gibbon... 100,000.00

Total .......................................................... $ 318,250.00

Balance of undistributed cash held for William Gibbon... $ 11,750.00

Note.—The details of the cash receipts and expenditures of this trust are shown in exhibit C.

JOHN GIBBON TRUST—JOHN DOE, TRUSTEE

Statement of cash receipts and disbursements for the period January 1, 1930, to December 31, 1934

<table>
<thead>
<tr>
<th>Distribution</th>
<th>Ethel Gibbon</th>
<th>William Gibbon</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount</td>
<td>$240,000.00</td>
<td>$180,000.00</td>
</tr>
<tr>
<td></td>
<td>$60,000.00</td>
<td></td>
</tr>
</tbody>
</table>

Receipts:

Dividends received (10,000 shares K. O. Corporation):
February 1, 1930................. $ 40,000.00
1931.................. 40,000.00 40,000.00
1932.................. 40,000.00 40,000.00
1933.................. 60,000.00 60,000.00
1934.................. 60,000.00

Total dividends.................. $240,000.00 $180,000.00 $60,000.00

Interest on K. O. Corporation bonds ($300,000 at 6% per annum):
June 30, 1930.................. $ 9,000.00 $ 9,000.00
December 31, 1930............ 9,000.00 9,000.00
June 30, 1931.................. 9,000.00 9,000.00
### Students' Department

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount 1</th>
<th>Amount 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1930</td>
<td>9,000.00</td>
<td>9,000.00</td>
</tr>
<tr>
<td>June 30, 1930</td>
<td>9,000.00</td>
<td>9,000.00</td>
</tr>
<tr>
<td>December 31, 1931</td>
<td>9,000.00</td>
<td>9,000.00</td>
</tr>
<tr>
<td>June 30, 1931</td>
<td>9,000.00</td>
<td>9,000.00</td>
</tr>
<tr>
<td>December 31, 1932</td>
<td>9,000.00</td>
<td>4,500.00</td>
</tr>
<tr>
<td>June 30, 1932</td>
<td>4,500.00</td>
<td>9,000.00</td>
</tr>
<tr>
<td>December 31, 1933</td>
<td>9,000.00</td>
<td>9,000.00</td>
</tr>
<tr>
<td>June 30, 1933</td>
<td>9,000.00</td>
<td>9,000.00</td>
</tr>
<tr>
<td>December 31, 1934</td>
<td>9,000.00</td>
<td>9,000.00</td>
</tr>
</tbody>
</table>

**Total interest:**
- $90,000.00
- $67,500.00
- $22,500.00

**Total income:**
- $330,000.00
- $247,500.00
- $82,500.00

**Disbursements:**

**Expenses:**
- From January 1, 1930, to September 30, 1933 (45 months at $100 per month): $4,500.00
- From October 1, 1933, to December 31, 1934 (15 months at $100 per month): $1,500.00

**Trustee's fees:**
- From January 1, 1930, to September 30, 1933, (3½ years at $5,000 per year): $18,750.00
- From October 1, 1930, to December 31, 1934: $6,250.00

**Total expenses:**
- $31,000.00
- $23,250.00
- $7,750.00

**Excess of income over expenses:**
- $299,000.00
- $224,250.00
- $74,750.00

**Payments to beneficiaries:**
- 1930: $27,250.00
- 1931: $35,000.00
- 1932: $25,000.00
- 1933: $54,000.00
- 1934: $46,000.00

**Total payments to beneficiaries:**
- $187,250.00
- $124,250.00
- $63,000.00

**Balances:**
- $111,750.00
- $100,000.00
- $11,750.00

**Payment to Ethel Gibbon trust:**
- 100,000.00

**Balance of cash on hand held for William Gibbon:**
- $11,750.00

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ETHEL GIBBON TRUST—JOHN DOE, TRUSTEE

Charge and discharge statement as to principal from September 1, 1933, to December 31, 1934

I charge myself with:
Cash received from the unexpended income due to Ethel Gibbon from the John Gibbon trust, which cash has been invested in 4% certificates of deposit $100,000.00

The above certificates of deposit belonging to the trust are still in the trustee’s possession at December 31, 1934.

Ethel Gibbon Trust—John Doe, Trustee

Charge and discharge statement as to income from September 30, 1933, to December 31, 1934

I charge myself with:
Interest received during the period on the 4% certificates of deposit (1½ years at 4% on $100,000) $ 5,000.00

I credit myself with:
Payment to the beneficiary, Joseph Hart during 1934 3,000.00

Balance, December 31, 1934 $ 2,000.00

The above balance belonging to the trust is represented by cash held by the trustee at December 31, 1934.

No. 6 (10 points):
On April 30, 1935, the X Y Z Corporation, a newly organized holding company, acquires all of the outstanding capital stocks of Companies A and B (the latter company owning the entire outstanding capital stocks of Companies C and D) by issuing all of its own stock share for share to the stockholders of Companies A and B.

It is established that:
(1) The earned surplus of Company A on April 30, 1935 was. . . . $150,000
(2) The earned surplus of Company B (including 85,000 representing the combined earned surplus accounts of Companies C and D on the dates they were acquired by B) was 235,000
(3) None of the companies A, B, C or D had a capital surplus on April 30, 1935
(4) The combined earnings of all companies for the two months ended June 30, 1935, were 60,000

Question A
How would you deal with the above items in the June 30, 1935, balance-sheet of the X Y Z Corporation? You are called into consultation by the directors of the X Y Z Corporation on July 15, 1935. They inform you that they wish to continue dividends of the same amount that the original stockholders of the subsidiary companies have been receiving regularly and that such amount would be $200,000.
Question B
State briefly the advice you would give them. You may assume that the earnings of Companies A and B and also the dividends paid to their respective stockholders have been equal.

Solution:
(A) From the statement of the problem it appears that the X Y Z Corporation was a holding company and had no income other than that received from its subsidiaries. The problem does not state the basis at which the investments in the subsidiary companies were recorded on the books of the holding company at the time of the exchange (April 30, 1935). Two bases may be used. The accounts may be shown (1) at the par value of the subsidiary companies stock accounts (the exchange was on a share for share basis), or (2) they may be written up to the book value of the underlying net assets of the subsidiary companies with the offsetting credit for the surplus accounts of the subsidiaries shown in the accounts of the X Y Z Corporation as "surplus of subsidiary companies at the date of acquisition". The earnings for the two months ($60,000) during which the subsidiaries were owned and controlled by the X Y Z Corporation may be taken up in its accounts by debiting the investment accounts and crediting "Earnings of subsidiaries during period of ownership." If method (1) is followed, the book value of the subsidiaries may be stated parenthetically in the balance-sheet of the X Y Z Corporation.

The financial condition of the X Y Z Corporation would be more clearly presented by means of a consolidated balance-sheet of all of the companies. In the preparation of a consolidated balance-sheet, the reciprocal accounts (the investment accounts in the subsidiaries on the holding company's books, and the capital stock and surplus accounts prior to the date of acquisition of the subsidiaries on the subsidiaries' books) would be eliminated and the assets and liabilities of the companies would be consolidated. The combined earnings ($60,000) since acquisition would be shown as consolidated surplus.

(B) The answer to this question depends upon the statutes of the state of incorporation of the companies. It is true that the X Y Z Corporation owns and controls the subsidiary companies and may, through the boards of directors of these companies, have dividends declared and paid to the X Y Z Corporation. From the viewpoint of the economist, the X Y Z Corporation has enjoyed an increase in its net assets of $60,000 during the two months' period of ownership. But from the legal viewpoint, the X Y Z Corporation has no earnings until it actually receives dividends from its subsidiaries, and may not pay any dividends to its stockholders until it realizes on the earnings of its subsidiaries.

A further complication is apparent when we consider the possibility of the subsidiary companies declaring and paying dividends in excess of the earnings during the period of holding ($60,000). Is the entire amount received as a dividend an earning, or should we treat all in excess of the earnings during the holding period as a return of capital or a reduction in the cost of the investment in the subsidiary? And does the fact that the X Y Z Corporation is carrying the investment accounts at book value, rather than at cost, change the situation?

I would discuss the question with the board of directors, and suggest that they consult the company's attorney for advice on the legal aspect of the question.
No. 7 (10 points):
Company A owns 80% of the capital stock of each of the companies B and C.
Company B owns 90% of the capital stock of Company D. Company C owns
95% of the capital stock of Company E. Company D sells to Company E real
estate costing $100,000 for $150,000 cash.
On the assumption that there was justification for the sale of the real estate
and that the selling price was the fair market value at the time of the sale, show
how the profit of $50,000 is to be treated in the consolidation of—
(1) Company B and its subsidiary, Company D
(2) Company C and its subsidiary, Company E
(3) Company A and its subsidiaries, Companies B and C

Solution:
(1) Consolidation of Company B and its subsidiary, Company D.
Company B owns 90 per cent. of the capital stock of Company D
which sold the real estate at a profit of $50,000 to Company E, which is
not in this particular consolidation. Therefore, Company B's interest
in the profit is 90 per cent. of $50,000 or $45,000, which amount may be
taken up in the consolidated surplus of the combined companies. The
minority interest of 10 per cent., or $5,000 should be shown separately
under the caption, minority interest.

(2) Consolidation of Company C and its subsidiary, Company E.
Company E was the company which purchased the real estate from
Company D. As the profit accrues to the selling company, and
neither Company C nor Company E has any interest in the selling
company, the consolidation of Companies C and E would not consider
the profit, as such. The cost of the real estate would be shown in the
consolidated balance-sheet of these two companies at $150,000.

(3) Consolidation of Company A and its subsidiaries, Companies B and C.
As Companies B and C own 90 per cent. and 95 per cent. of Companies
D and E, respectively, these latter companies also should be in-
cluded in the consolidation. However, a reserve for the intercompany
profit in the sale of the real estate by Company D to Company E
should be reflected in the consolidated balance-sheet as a deduction
from the cost to Company E; i.e., $150,000. The question to be
answered is—What is the amount of the profit on this sale to the con-
solidation?

If we bear in mind that the problem is to eliminate any profit in the
surplus account of the selling company which might otherwise
be taken up in the consolidated surplus account, we find:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit to Company D</td>
<td>$50,000</td>
</tr>
<tr>
<td>Share of profit to Company B (90% of $50,000)</td>
<td>45,000</td>
</tr>
<tr>
<td>Share of profit to Company A (80% of $45,000)</td>
<td>36,000</td>
</tr>
</tbody>
</table>

If the sale of the real estate had been made to a company outside of the con-
solidation, the consolidated surplus account of Company A and all of its sub-
sidiaries would show $36,000. The difference between this amount and the
$50,000 profit shown on the books of Company D would be the minority interests' share of the profit. However, as the "sale" was made to another company within the consolidation, the holding company's interest in the profit must be eliminated by setting aside a reserve of $36,000 for the inter-company profit which will appear in the consolidated balance-sheet as a deduction from the real estate valued at $150,000.
Book Reviews


C. P. A. Law Questions and Answers, notwithstanding its title, deals solely with the commercial-law examinations of the American Institute of Accountants, beginning with the examination of November 13, 1925, and ending with that of May 17, 1935. Each question and the author's answer to it are printed without the citation of authorities, and in appendices are given the negotiable instruments law (statute), the uniform sales act and the uniform partnership act. The book is indexed under twenty main subject headings. This probably is a practical plan because any one using the book presumably would know the subject heading under which the topic sought would be found. The book is excellent for review or quiz purposes but it is neither intended nor suitable for original study. Memorizing its entire contents would not enable a candidate to pass the next examination, because the questions themselves are not repeated and the points of law raised in them have to be pretty well understood to be recognized and applied to new sets of facts or new arrangements of definitions in subsequent examinations.

In an interesting introduction the author contrasts the questions of the last ten years with the earlier Institute questions and finds an improvement in that the later questions cover a much wider range of law. The author failed to notice, or at least to comment upon, the fact that federal-income-taxation questions have not been asked since the examination of May 18, 1934. This will be an aid in further expanding the scope of subjects covered. The author's belief that some of the law questions are unusually difficult for the average student of business should not be disturbing to future candidates, because each examination paper states in a head-note: "Answers will be graded according to the applicant's evident knowledge of the legal principles involved in the question rather than on his conclusions." Thus a well reasoned answer to a seemingly difficult question should be given a good grade regardless of the conclusion reached. Fairness would require this, when law is so inexact a science that the United States supreme court sometimes divides five to four. What the examiners undoubtedly want is an answer based on the application of principles of law and not merely the candidate's conclusion as to what ethics or morality would in his opinion require in the circumstances of the specific case. "Reasons must be stated for each answer" means the application of principles of law. Incidentally, an elaboration or restatement in many words of the conclusion reached probably will not delude the examiners into mistaking it for the statement of a reason.

One of the valuable features of this book is the set of suggestions made by the author as to the technique, or mechanics as he terms it, of writing answers to examination questions. All of them are excellent, but the temptation to add at least two others is too strong to resist. First, when the candidate believes a contract, negotiable instrument or other document to be defective, let him state concisely why he so regards it, but let him refrain from listing all of the elements which are required for a perfect instrument. To list all of that irrelevant matter
as a parade of his assumed knowledge is as childish a form of padding as is the repetition of the whole or part of the question itself. Doubtless many a good answer has been reduced to fair or worse by the dangerous practice of volunteering information, some of which may disclose that the candidate after all is not soundly informed. It is apt to prove disastrous over-selling. Secondly, while the answers should be submitted in numerical order, they should be written along the line of least resistance. Those which the candidate regards as easy should be answered first. That practice gives him a sense of accomplishment when he sees how many questions he has answered and it leaves him free to devote himself wholly to the questions which are troublesome. If he struggles too much with the latter type of question at the outset, he may not be able to complete his answers to the easy questions within the time limit and thus fail to submit a sufficient number of answers to procure a passing grade. Each answer should be begun on a separate sheet of paper; and except in the most unusual situation, let it be concluded on that same sheet.

The author’s answers are sound and well written, although I do not agree with all of them. But has it not been admitted that law is not an exact science? Although the author states that his answers are not intended to be models as to form, it is to be regretted that he has not always given his answer first and then stated his reasons. Not only does an examiner dislike to have to read half a page or more before he discovers the candidate’s conclusion, but the candidate is apt to write a better answer if he starts with his conclusion and then explains and defends it. If he wanders back and forth from one side of a question to the other, he may land in the middle without reaching any definite conclusion. Also, the head-note on the examination paper states: “Whenever practicable, give the answer first and then state reasons.” I can think of nothing to be gained by failing to comply with a reasonable instruction imposed by the person whose good opinion the candidate is seeking.

It is a good and useful review book for candidates.

Harold Dudley Greeley.

ANALYSIS OF FINANCIAL STATEMENTS, by Harry G. Guthmann.

Analysis of Financial Statements is a revision of a previous edition, first published in 1925, which takes into account many of the important changes in corporation practice and finance which have occurred within the last ten years. The plan of the book is logical, general considerations occupying the first ten chapters and their application to specific types of business forming the remaining eight chapters. The general section of the book presents a good summary of generally accepted methods of analysis. There are numbers of illustrative examples and the different points which the author makes are supported by references to actual corporate reports or to recognized authorities. It is interesting to note that the author (page 5) takes much the same view of organization as that of Gilbert K. Chesterton who, in one of his characteristic attacks on modern society, said that organization was merely a substitute for the personal control of an enterprise and that the less there was of it the better. The author says: “Today the ability to analyze financial reports is essential to bridging the gap in personal relationships created by the size of our business units.”
In a book of this size which covers such a wide field it is inevitable that one would disagree with the author on some points. For example, on page 17 he implies that the goal toward which the securities and exchange commission should work is a type of regulation and uniformity comparable to that exercised by the interstate commerce commission. Referring to the securities and exchange commission the author says: "Its power would appear to be sufficient so that it could require full information from industrial and other corporations on a plane somewhat approaching that set by the interstate commerce commission for railroads after 1906." Most observers of the workings of the interstate commerce commission, particularly in relation to uniform accounts, would hardly like to see this type of superficial uniformity imposed on business in general, and the record of the securities and exchange commission so far does not indicate that this is its aim.

Among the chapters devoted to special industries that on mining is one of the best. The author wisely refrains from any dogmatic statements as to just what should or should not be included in the report of a mining company, but he does show the relation between the statistical information generally included in mining-company reports to the financial statements and makes it clear to the analyst or investor that it is unwise to attempt to draw conclusions from either type of information considered separately.

The chapter on holding companies is also valuable as an exposition of current practice in that field.

While a number of the important developments of the last ten years have been covered in this book, those which have to do with the devaluation of the dollar, foreign currency restrictions, and the disorganization, in many countries, of the foreign-exchange market have either been overlooked or barely mentioned.

It seems strange that in a chapter on statements of insurance companies nothing should be said about effect of devaluation which causes the arbitrary transfer from the holders of bonds, debentures and other fixed interest securities to holders of equity securities of a large part of the assets of those companies which have issued securities of both kinds, without compensation for this loss to the holders of the securities carrying fixed rates of interest. One would think also that in a discussion of statements of insurance companies, particularly those having to do with life insurance, some mention would be made of the loss to policyholders (already felt in reduced dividends) and to stockholders brought about by the present treasury policy of forcing down interest rates and keeping them at an extremely low level, as well as the probable decline in price of bonds purchased at the present time carrying these low rates when interest rates rise as capital becomes more fully employed.

These criticisms are not intended to detract in any way from the statement that this is an excellent book on a difficult and widely inclusive subject but are merely to indicate that no matter how well prepared a book on financial statements may be it can not cover anything and can not be used as a substitute either for a careful scrutiny and analysis of day-to-day developments or for the exercise of the independent judgment of the individual analyst.

Maurice E. Peloubet.
Accounting Questions

[The questions and answers which appear in this section of The Journal of Accountancy have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

VALUATION OF INVENTORIES OF METAL MINING COMPANIES

Question: A company in the metal mining and milling business has its stock listed on the New York stock exchange and is required to report quarterly to the exchange the net income and the amount of net income a share on the outstanding stock. The company's finished product is concentrates, which customarily are shipped under contract to the smelter as soon as they are produced. Recently the company has stored part of its production in expectation of better metal prices, and the stored concentrates are valued in the company's accounts at mining and milling cost, which is less than market. During a period in which the stored concentrates increase, the net income is less than it would be if the concentrates had all been sold or if net income had been computed on the basis of valuing them at market. Conversely, for a period in which the inventories of stored concentrates are reduced by shipments to the smelter, income is greater than if it were computed on the market value of the stored concentrates.

The officers of the company feel that a statement of net income computed on the basis of inventories stated at cost has the effect of distorting the income from what is actually made as the produce is readily marketable and sold as soon as placed on the cars for shipment at the price determined by the market quotations of the various metals.

The question concerning which we desire your opinion and suggestions relates to the presentation of operating results so as to avoid misleading investors and stockholders and, in particular, we would be much obliged to be informed if it would be proper and is customary with metal mining companies to state inventories at market. We believe this practice was followed in earlier years by large operators but has largely been discontinued on account of income-tax regulations which prohibit the use of inventories at a higher value than cost.

We have suggested to the company that report be made to the New York stock exchange along the lines of the following paragraph and would appreciate
your opinion as to the propriety of such a statement in which income is taken into account before fully realized:

"The ........... Mining Company for the quarter ended June 30 made a net profit of $........... after taxes and depreciation but before depletion, which is equal to $........... a share on the ............ shares of $........... par common outstanding. During the quarter inventories of concentrates which are being stored in anticipation of higher metal prices and are valued at cost were increased. Net income for the quarter based on valuing inventories of concentrates at market was $........... which is equal to $........... a share on the outstanding common."

During periods of decreasing inventories the report would indicate conversely a smaller net income on basis of inventories at market than at cost.

**Answer No. 1:** It is not customary for mining companies to value their inventories at market except in the case of by-products such as precious metals produced with the mining of copper, lead, zinc or other primary metals. The exception to this is that when the market value is less than cost the inventories are usually reduced to market.

In the case of your client we believe the net profit should be shown on the cost basis. It also seems proper to us to give the additional information shown in the second part of your proposed paragraph. This is on the assumption that both beginning and end inventories are valued for this purpose on the basis of the market price at the respective dates.

Would it not be better to make the last sentence of your paragraph read "Net income for the quarter if calculated on a basis of valuing inventories of unsold concentrates at market values both at the beginning and end of the period was $........... which is equal to $........... a share on the outstanding common stock"?

The net income of a company which stores metals such as you have described will necessarily be made up of two elements, the profit on operations based on the market price of the product at the time of production and a speculative profit or loss reflecting the difference between this market value and the amount eventually realized for the product. Although it is not usual to recognize such a segregation either in the accounts or in reports to stockholders in certain circumstances, it would seem that such a segregation might be necessary to give proper information as to the results of operations.

"Two other members of the Institute have submitted suggestions for the last sentence in the proposed report of the company to the New York stock exchange as follows:

1. Net income for the quarter based on valuing inventories of concentrates at market rather than cost would have been $........... which would be equal to $........... a share on the outstanding common stock.

2. Net income for the quarter would have been increased by $........... if the increase in the inventories of concentrates had been valued at market instead of at cost."

**Answer No. 2:** From the standpoint both of income taxes and financial accounting, it is in our opinion best to state inventories of concentrates at cost rather than at market value. Market would of course be used if lower than cost at the date of a balance-sheet.

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Accounting Questions

While we understand that the concentrates could be readily sold, the same would be true of many items in the finished-goods inventories of most companies, and it does not seem advisable in the circumstances mentioned to depart from the usual practice of carrying inventories at cost if cost is below market and stating income accordingly.

We approve the idea of a special statement to the New York stock exchange setting forth the facts and calling attention to the difference of earnings if the inventories of concentrates were valued at market rather than cost, but we recommend that the last sentence should read as follows:

"Net income for the quarter based on valuing inventories of concentrates at market rather than cost would have been $............, which would be equal to $............ a share on the outstanding common stock."

CLASSIFICATION OF FUNDED DEBT

The following letter did not pass through the bureau of information of the American Institute of Accountants but was written by the chairman of the special committee on accounting procedure in response to an inquiry. Its general interest merits publication, but it must not be regarded as an official expression of the Institute:

Answering your request for an authoritative opinion on the procedure considered preferable for disclosing and classifying funded debt falling due within one year from the date of the balance-sheet, it appears that most accountants do not take serious objection to either of the methods outlined by you, namely: (1) classifying all instalments on bonds due within one year as current liabilities or (2) showing the total funded debt as a deferred obligation with proper notations describing the sinking fund or serial maturities to be met in the coming year. However, certain accountants have expressed a preference for one or the other of these two methods, and an attempt will be made to summarize the reasons which they have advanced in support of their views.

At the outset, it should be pointed out that the regulations of the securities and exchange commission require instalments of funded debt due within one year to be classified as current liabilities but do not require sinking-fund payments to be so classified. This classification is followed by a number of companies and is advocated in the pamphlet Reports to Stockholders. It must, therefore, be recognized that this procedure is considered acceptable accounting practice.

The arguments of those who support this view may be summarized as follows:

Serial maturities of funded debt maturing within one year should be classified as current liabilities, unless there is definite knowledge that they are not to be paid—which is seldom the case. As to entire issues maturing during the year, the treatment depends upon whether or not the bonds are expected to be paid or may be refunded in some manner. They should be treated as current liabilities unless there is reason to believe that they will not be paid, and in that case, it is desirable to state in the balance-sheet that the total of current liabilities is exclusive of funded debt maturing within a year. The question of real-estate mortgages—which are practically in the same category as funded debt—is sometimes a troublesome one. Frequently, we have real-estate mortgages
which are even past due but are not expected to be paid in the near future. Superficially, these are demand obligations, but practically, in many cases, it is unfair to the client to treat them as current liabilities. In such cases, at least the amounts and dates of current maturities should be disclosed, and in many, if not all, of such cases the total current liabilities should be qualified as excluding past-due mortgages or those maturing within a year.

Manifestly, if any bonds which mature within a year are held in the treasury, they should be deducted from those which are to be shown as current liabilities. Also, if there are deposits with trustees which can be definitely identified with bonds maturing within a year, and such bonds are classified as current liabilities, the deposits should be classified as current assets.

The following is a summary of the views of those who advocate showing the total funded debt as a deferred obligation with suitable notations as to maturities.

A balance-sheet would appear to be more informative when the total of one kind of liability, such as a class of bonds, is included as one amount with suitable notations as to maturities. It does not seem desirable to follow literally the rule that all amounts due within one year should be included in current liabilities. The current liabilities can not be considered to represent the cash outlay which will have to be made in the next year and the changes in almost all of the balance-sheet accounts will be affected by the payment of the liabilities and by other transactions of the year. The funds to pay an instalment of a debt when it becomes due may be the result of profits earned subsequent to the date of the balance-sheet. An interpretation of a balance-sheet depends upon comparisons and analyses, only one of which is the ascertainment of the ratio of current assets to current liabilities; and due consideration must be given to other factors.

There seems to be general agreement that no different treatment of funded debt instalments due within a year should be adopted as between companies earning a profit and those which are not.
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HOLDING COMPANIES
Accounting

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IRON AND STEEL
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STOCK EXCHANGES
Government Regulations

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TAXATION
United States Corporations

Estates and Trusts

Income and Excess Profits

Income and Excess Profits
Partnerships

Social Security

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Accountants' Magazine, 23 Rutland Square, Edinburgh, Scotland.
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